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New Day for Nonstock Corporations: The 2010 Amendments to Delaware's General Corporation Law

*By John Mark Zeberkiewicz and Blake Rohrbacher**

In August 2010, Delaware's General Corporation Law (DGCL) was amended to clarify the application of the DGCL to corporations not authorized to issue capital stock, commonly known as nonstock corporations. Delaware has thousands of nonstock corporations, including both for-profit and nonprofit entities, but the DGCL's focus has traditionally been on stock corporations. The largest amendments to the DGCL in more than forty years, the 2010 nonstock amendments covered nearly every area of the corporate law—clarifying, filling gaps in, and making consistent the DGCL's treatment of nonstock corporations. This article describes the impetus for the nonstock amendments and explains the structure and nuances of those amendments.

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* John Mark Zeberkiewicz and Blake Rohrbacher practice corporate law at Richards, Layton & Finger, P.A., in Wilmington, Delaware. Attorneys at Richards, Layton & Finger, including the authors, were involved in drafting some of the legislation discussed herein, but the opinions expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients. The authors would like to thank Donald A. Bussard for his thoughts and thoughtfulness and for his willingness to share his considerable knowledge, both in the preparation of this article and in the preparation of the nonstock amendments, and James L. Holzman for being an early champion of this article and of the nonstock amendments.

Delaware law has changed dramatically for thousands of Delaware corporations—in a way that should change very little for them. That is, a large number of amendments have been made to the General Corporation Law of the State of Delaware ("DGCL"), but the effect of those amendments was chiefly to clarify the application of the DGCL to corporations not authorized to issue capital stock (commonly known as nonstock corporations). On April 28, 2010, Delaware's General Assembly approved House Bill 341, the legislation containing the nonstock amendments; the bill was signed by the Governor on May 3, 2010.[1] The amendments became effective on August 1, 2010.

The bill signed by Governor Jack Markell was a comprehensive set of amendments to many sections of the DGCL (and to Chapter 5 of Title 8 of the Delaware Code) to clarify, fill gaps in, and make consistent the DGCL's application to nonstock corporations. Delaware has not provided a separate statute for nonstock corporations, but has instead dealt with such corporations within the ambit of the DGCL, which is geared largely toward stock corporations. As a result, nonstock corporations have long faced difficult questions about the DGCL's application. The nonstock amendments were intended to provide clarity and consistency so that these entities and their advisors have the appropriate and necessary statutory guidance to organize their internal affairs and conduct their operations. Delaware's nonstock corporations now enjoy the advantages shared by Delaware's stock corporations: a complete and up-to-date statutory foundation.

1. 77 Del. Laws ch. 253 (2010).

The centerpiece of the nonstock amendments is new Section 114—a "translator" provision setting forth which provisions of the DGCL apply to all nonstock corporations and which of those provisions apply specifically to nonprofit nonstock corporations. Along with Section 114, the amendments wrought other changes; most of the changes were technical in nature, but some were substantive changes to the then-current law regarding nonstock corporations. Among the substantive changes, the amendments generally streamlined or modernized procedures applicable to nonstock corporations, extended new powers to nonstock corporations (e.g., the power to effect certain short-form mergers with a stock-corporation subsidiary), or codified preexisting features of nonstock corporation law (e.g., deeming the capital of nonstock corporations to be zero). The amendments also clarified the law and set forth a distinct statutory framework for nonprofit nonstock corporations, thereby providing (in substance, if not in form) a distinct Delaware law for not-for-profit entities, within the general corporate framework.

In this article, we review the reasons why Delaware enacted the nonstock amendments and explain the amendments themselves, with an eye toward providing practitioners insight into the strength and flexibility of Delaware's enhanced nonstock law. Entities headquartered around the globe take advantage of Delaware's nonstock law to ensure both the benefits of being incorporated in Delaware (including having access to Delaware's efficient and responsive Secretary of State for corporate filings as well as Delaware's world-renowned court system) and the benefits of operating not-for-profit. Those entities now have a stronger statutory foundation and will be able to manage their business and affairs in a more certain, secure, and flexible manner. But the real advantage is for those wishing to take advantage of Delaware's corporation laws without being subject to certain procedural requirements (such as annual meetings) necessary for stock corporations. The 2010 amendments,[2] and the legal certainty created thereby, should make the decision to incorporate small businesses as Delaware nonstock corporations an easy one. In this article, we will explain briefly the advantages to practitioners of Delaware's revised nonstock corporation law—for both nonprofit and for-profit entities and their managers.

I. Why Were the Nonstock Amendments Necessary?

Before explaining the changes Delaware made to its nonstock corporation law, it may be instructive to consider the reasons those changes were made. Although Delaware is home to many thousands of nonstock corporations, the law applicable to Delaware's nonstock corporations has never been as clear as that for stock corporations. As Professor Ernest Folk (one of the principal figures in Delaware's

2. As used in this article, the "2010 amendments" refer only to the 2010 nonstock amendments, 77 Del. Laws ch. 253 (2010), and not to the other amendments to the DGCL enacted in 2010, 77 Del. Laws ch. 290 (2010).

1967 revision of its general corporation law[3]) recognized in 1972, the DGCL, "although applicable to nonprofit and nonstock corporations alike, has not systematically treated this type of entity, although many such corporations are organized under the Delaware statute."[4]

Rather than having separate statutes for stock and nonstock corporations (or for for-profit and nonprofit corporations) like many other states, Delaware has instead chosen to retain a general corporation law that applies to both stock and nonstock corporations. The DGCL has contained provisions regarding nonstock corporations for more than 100 years. For example, Section 242 has included provisions regarding nonstock corporations since 1901,[5] and Section 215 has included provisions regarding nonprofit corporations since 1927.[6]

Part of the problem with Delaware's law regarding nonstock corporations is that the purpose of these entities was never perfectly clear. The provisions added to Section 215 in 1927 technically applied to nonprofit corporations, which were presumed to be nonstock corporations. Indeed, Professor Folk, when writing his report for the Delaware Corporation Law Revision Committee, made the converse presumption as well: that all nonstock corporations would be operated not for profit.[7] But nonprofit corporations are not synonymous with nonstock corporations; nonstock corporations may be operated either for profit or not for profit.

The DGCL was therefore stretched to include additional types of corporations, although its focus was squarely on stock corporations. Provisions regarding nonstock corporations were largely add-ons to provisions regarding stock corporations (such as subsection 141(j)) or were incomplete attempts to replicate (or modify, as necessary) other provisions regarding stock corporations (such as Sections 215 and 255). Either way, nonstock corporations had never been fully integrated into the DGCL, and only a small fraction of the sections in the DGCL expressly addressed nonstock corporations. This situation led, unsurprisingly, to a lack of clarity regarding the DGCL's application to nonstock corporations as a general matter.

Delaware has wrestled with these issues for some time. For example, current subsection 141(j) took several twists and turns before the drafters settled on a satisfactory solution:

> Prior to the 1967 revision, § 141 provided that none of its subsections governed nonprofit corporations except for the statutory authorization of director action by written consent in lieu of a meeting. Since this limiting language seemingly denied nonprofit entities many convenient and liberal rules found in § 141, the 1967 revision declared that § 141 would apply to nonprofit corporations to [a certain extent]. Section 141(h), as revised in 1967, also broadly authorized the nonprofit corporation

3. *See, e.g., Dogsbodies of the DGCL: Revisiting Roles in the Landmark Achievement*, Del. Law., Spring 2008, at 10, 12.

4. Ernest L. Folk, III, The Delaware General Corporation Law: A Commentary and Analysis 66 (1972).

5. 22 Del. Laws ch. 167, § 26 (1901).

6. 35 Del. Laws ch. 85, § 9 (1927).

7. *See* Ernest L. Folk, III, Review of the Delaware Corporation Law 136 n. (1965–1967) ("[T]he redraft makes Sections 212–214 inapplicable to non-stock non-profit corporations; by implication,

to organize and conduct its internal affairs as it saw fit by provisions of its certificate of incorporation.

Inexplicably, the 1969 amendments dropped § 141(h) entirely, presumably on the theory that it was unnecessary, since the 1969 amendment to § 141(a) allowed all corporations to depart from the corporate norm by charter provision. The effect of this deletion was to leave virtually no statutory base for the law relating to nonprofit corporations nor any guidance as to the expedient direction of its internal affairs.

The 1970 amendments reverse the 1969 action by substituting, in new § 141(j), an expanded and improved version of the 1967 provisions regarding nonprofit corporations.[8]

A. Issues of Interpretation

Among the most significant of the pre-amendment problems with the DGCL's treatment of nonstock corporations were the open questions of its applicability. Some provisions of the DGCL expressly addressed nonstock corporations, while others did not. That situation fed practitioners' confusion for two reasons: First, even if a given section arguably should have applied to nonstock corporations, practitioners could not know for certain that it applied—if it contained no express reference to nonstock corporations. Second, because some sections did contain language expressly relating to nonstock corporations, greater doubt was created that sections without such language also applied to nonstock corporations.

Often, the most logical conclusion—that a section referring to "stockholders" but not "members" did not apply to nonstock corporations—was unsatisfactory from a policy perspective. For example, Section 145, which provides a corporation with the power to indemnify and advance legal expenses to its directors, officers, employees, and agents (and sets forth the limitations on that power), contains references to "directors" and "stockholders," but it does not contain references to "members of the governing body" or "members."[9] Before the 2010 amendments, a logical interpretation could have been that nonstock corporations had no power to indemnify or advance legal expenses to the members of their governing bodies, officers, employees, or agents.

Furthermore, the Delaware courts—using standard canons of statutory interpretation—made the applicability issue explicit in specific instances. In 1994, the Delaware Court of Chancery in *Scattered Corp. v. Chicago Stock Exchange, Inc.* refused to "find that the Legislature intended that the term 'stockholder,' as used . . . throughout the DGCL, includes members of nonstock corporations except where otherwise provided."[10] For that reason, the court

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they would apply to all stock corporations (profit and non-profit) and (*if such ever existed*) a non-stock corporation for profit. Again . . . , the redraft . . . states rules applicable to all non-stock corporations which will, in practice, *mean only non-profit enterprises*." (emphasis added)).

8. Folk, *supra* note 4, at 66–67 (footnotes omitted).

9. Del. Code Ann. tit. 8, § 145 (2010). All cites to the Delaware Code Annotated are to the Online Delaware Code, http://delcode.delaware.gov/ (last visited Dec. 13, 2010).

10. 671 A.2d 874, 877 (Del. Ch. 1994).

held that Section 220 (regarding demands for corporate books and records) did not apply to nonstock corporations.[11] As the court explained,

> if "stockholder" were intended automatically to include members of nonstock corporations . . . , then all sections of the DGCL that expressly include members of nonstock corporations would become surplusage. It is a fundamental rule of construction that a statute should not be construed in a manner that renders part of it surplusage.[12]

Similarly, the Delaware Supreme Court—when addressing a question of notice in the nonstock context—suggested that Section 222 (referring to "stockholders") would apply only "by analogy."[13] The Delaware Supreme Court also stated that Section 144 (which at the time referred to "shareholders"[14]) was "not, by its terms, directly applicable to a nonstock corporation."[15]

Efforts to address this DGCL-wide issue in specific instances only exacerbated the problem. For example, Section 220 was amended in 1995 to reverse the *Scattered Corp.* holding.[16] Before the 2010 amendments (in which this language was deleted), Section 220 contained language making express Section 220's application to nonstock corporations.[17] But that section-specific fix, by its very nature, suggested that, by not amending the *other* sections of the DGCL, Delaware's General Assembly truly intended that those other sections not apply to nonstock corporations.

This issue of interpretation led to a lack of confidence that many important provisions of the DGCL would apply to nonstock corporations. The 2010 amendments were designed, in large part, to rectify this situation and to make clear which sections of the DGCL applied to nonstock corporations and which did not.

B. Other Issues

The pre-amendment DGCL also contained other traps and gaps that required fixing. For example, the pre-amendment DGCL used several different phrases to refer to nonstock corporations.[18] While these terms were generally similar, argu-

11. *See id.* at 880.
12. *Id.* at 879.
13. Farahpour v. DCX, Inc., 635 A.2d 894, 900 (Del. 1994).
14. After the 2010 amendments, the term "shareholders" was replaced with the term "stockholders" for the sake of consistency and to ensure proper translation. The DGCL now refers only to "stockholders," and the term "shareholders" no longer appears in the DGCL.
15. Oberly v. Kirby, 592 A.2d 445, 467 (Del. 1991) ("8 *Del. C.* § 144 is not, by its terms, directly applicable to a nonstock corporation.").
16. S.B. 175, 138th Gen. Assem. (Del. 1995) ("These amendments to Section 220 are adopted in response to the decision of the Court of Chancery in *Scattered Corp. v. Chicago Stock Exchange, Inc.*, Del. Ch., C.A. No. 13703, Jacobs, V.C. (December 2, 1994) and expand the definitions of 'stockholder' and 'list of stockholders' to include members of nonstock corporations and lists of those members.").
17. Del. Code Ann. tit. 8, § 220 (2009), *amended by* 77 Del. Laws ch. 253, §§ 20–23 (2010).
18. *See, e.g.*, *id.* §§ 102(a)(4) ("corporations which are not to have authority to issue capital stock"), 141(j) (corporations "which [are] not authorized to issue capital stock"), 215(a) ("corporations not authorized to issue stock"), 225(a) ("corporation[s] without capital stock"), 255(b) ("nonstock corporations"), 312(j) ("corporation[s] not for profit and having no capital stock").

ments could have been made that, for example, "nonstock corporations" were not the same as corporations "without capital stock" (which could refer to stock corporations that had not yet issued stock) or corporations "not authorized to issue stock."

Other inconsistencies had to do with basic requirements and terminology regarding members. Pre-amendment, the DGCL did not appear to require expressly that nonstock corporations have members. Subsection 102(a)(4) came the closest, requiring nonstock corporations to provide for the "conditions of membership."[19] But the pre-amendment DGCL provided no consequences for a nonstock corporation that lacked members or conditions of membership.[20] The 2010 amendments addressed these situations by providing nonstock corporations with clear guidance to remedy the defects. Furthermore, the pre-amendment DGCL referred to "memberships" and "membership interests," both in ways that seemed interchangeable and in ways that seemed distinct. The 2010 amendments drew an important distinction between the two terms.

Finally, the pre-amendment DGCL lacked (or appeared to lack) important guidance for nonstock corporations. Before the amendments, nonstock corporations and their advisors were without statutory guidance on record dates;[21] whether members of nonstock corporations could differ by class, type, or voting right;[22] and the differences between nonstock corporations operated for profit and those operated not for profit. The 2010 amendments were intended to address each of these issues as well.

II. The Nonstock Amendments

The 2010 nonstock corporation amendments contained a number of fixes, both substantive and technical. We will attempt to explain the amendments by first addressing the basic principles behind the amendments and then analyzing the amendments section by section. The first section we address is new Section 114, which is the key to the amendments, and then we proceed through the DGCL in order, discussing the changes made in each subchapter.

A. Basic Principles

The guiding principles behind the 2010 nonstock corporation amendments were several: (1) to "codify common sense"; (2) to "touch" as little as possible; and

19. *See also* Oberly v. Howard Hughes Med. Inst., 472 A.2d 366, 392 (Del. Ch. 1984) (suggesting that "the statutes require that a nonstock corporation have 'members' as opposed to shareholders" (citing Del. Code Ann. tit. 8, § 102(a)(4))).

20. *Cf*. Read v. Tidewater Coal Exch., Inc., 116 A. 898, 906 (Del. Ch. 1922) ("[I]f it be true that the conditions of membership were not sufficiently set out in the certificate, that one circumstance will not be allowed to render the assumed corporation a mere nullity.").

21. Pre-amendment Section 215 expressly provided that Section 213 did not apply to nonstock corporations.

22. Some provisions seemed to presume different classes of members, but the portion of pre-amendment subsection 102(a)(4) that provided for classes of stock expressly did not apply to nonstock corporations.

(3) to avoid imposing on existing nonstock corporations any new or additional burdens or obligations.

The nonstock amendments were intended to confirm that nonstocks operate in the way most practitioners have always thought they did[23]—not to effect a change in the way nonstocks operate. When possible, therefore, the amendments retained the result that, by logic or policy, was the most sensible result under the pre-amendment DGCL (notwithstanding the statutory construction issues noted above). With a few minor exceptions, the amendments were intended largely to *clarify and confirm* that the DGCL applies to nonstock corporations in a certain way.

The amendments rewrote as little of the DGCL as possible; existing language was generally left alone. Some changes were necessary, but most of them involved technical changes, such as deleting nonstock-specific language no longer necessary post-amendment,[24] changing phrases to allow[25] or prevent[26] the application of provisions generally applicable to stock corporations, and providing duplicate provisions where necessary.[27]

As a result of these principles, practitioners using the post-amendment DGCL to address stock corporations should notice very little difference from the pre-amendment DGCL. And practitioners using the post-amendment DGCL to address nonstock corporations should be able to employ not only their preexisting knowledge of Delaware nonstock law but also their knowledge of Delaware law regarding stock corporations. That said, most statutory questions involving Delaware nonstock corporations will begin with an analysis of Section 114, the translator provision.

B. Section 114—The Translator Provision

New Section 114 of the DGCL is the key to the nonstock amendments. It provides the method by which much of the DGCL applies to nonstock corporations, it sets forth the basic definitions governing nonstock corporations, and it provides (in effect) a comprehensive nonprofit law for Delaware nonstock corporations. The structure and operation of Section 114 may appear abstruse at first, but basic familiarity and a modicum of practice should make its use both intuitive and simple. We intend the following discussion to provide a helpful guide to the use and analysis of Section 114.

Several different options could have been chosen to address the issues with the pre-amendment DGCL. From one standpoint, the clearest solution might have been to create a completely new nonstock statute, one modeled after the DGCL, with appropriate revisions. But that might have required a third standalone stat-

23. As noted above, however, it is not perfectly clear that practitioners' practical understanding of nonstock law would have passed muster in the courts if challenged. *See, e.g.*, text accompanying *supra* notes 11–17.

24. *See, e.g.*, 77 Del. Laws ch. 253, §§ 29–30 (2010).

25. *See, e.g.*, *id.* §§ 12–14.

26. *See, e.g.*, *id.* § 16.

27. *See, e.g.*, *id.* §§ 3–4.

ute, to deal with nonprofit nonstock corporations, and would have departed from Delaware's historical practice of a single general corporation law. A new subchapter could have been created to cover all necessary nonstock provisions, but that would have been difficult to use and would have provided only a partial solution (as the subchapter would have had to include nearly the entire DGCL). The solution chosen was more efficient: a single new section that creates a nonstock corporation law (and, in effect, a nonprofit nonstock corporation law) largely by translating the current DGCL into nonstock-corporation terms.

Section 114 has four operative provisions. Subsection 114(a) generally provides that—except as set forth in subsections 114(b) or 114(c)—the provisions of the DGCL apply to nonstock corporations. It also sets forth the manner in which the DGCL applies to nonstock corporations by translating the stock-corporation terms in each applicable section into nonstock-corporation terms. Subsections 114(b) and 114(c) contain lists of sections and subchapters of the DGCL that are not translated by subsection 114(a). Through those three subsections, Section 114 creates, in effect, a complete corporation law applicable to nonstock corporations and another one applicable to nonprofit nonstock corporations. Finally, subsection 114(d) sets forth four crucial definitions relating to nonstock corporations: "nonstock corporation," "membership interest," "nonprofit nonstock corporation," and "charitable nonstock corporation." Each of the four subsections is discussed more thoroughly below, beginning with the definitions in subsection 114(d).

1. Subsection 114(d)—Definitions

Subsection 114(d) defines four key terms relating to nonstock corporations: "nonstock corporation," "membership interest," "nonprofit nonstock corporation," and "charitable nonstock corporation."

The first term, "nonstock corporation," is largely a definition of convenience, intended to replace the old phrase "corporation organized under this chapter that is not authorized to issue capital stock." No change in meaning from the pre-amendment DGCL is intended from the variety of phrases that were used to refer to such corporations.[28]

The second term, "membership interest," is more significant, since (as described below) it forms the difference between nonprofit nonstock corporations and all other nonstock corporations.[29] Based originally on the definition of "limited liability company interest" from the Delaware Limited Liability Company Act,[30] the nonstock "membership interest" definition relies on two basic concepts, either of

28. *See supra* note 18 (listing some of the phrases used to refer to nonstock corporations in the pre-amendment DGCL).

29. *See* Del. Code Ann. tit. 8, § 114(d)(3) (2010) (defining "nonprofit nonstock corporation").

30. Del. Code Ann. tit. 6, § 18-101(8) (2010) (defining the term to mean "a member's share of the profits and losses of a limited liability company and a member's right to receive distributions of the limited liability company's assets").

which (or both of which) may be sufficient: a share in the "profits and losses of a nonstock corporation," and a right to "receive distributions of the nonstock corporation's assets."[31] The definition is also flexible, allowing a nonstock corporation to provide otherwise in its certificate of incorporation.

Regardless of how a specific nonstock corporation's "membership interests" are defined, the definition of "nonprofit nonstock corporation" ensures that no nonstock corporation having membership interests, allowing its members to share in the profits or losses of the corporation, or affording its members the right to receive distributions of the corporation's assets, will be a nonprofit nonstock corporation.[32] As noted below,[33] the consequences of qualifying as a nonprofit nonstock corporation are generally that members hold memberships (not membership interests) that are not personal property, that members may not receive dividends, that the corporation may not sell its memberships, and that the corporation may not repurchase the members' memberships. Therefore, the negative definition of "nonprofit nonstock corporation" relies on the definition of "membership interest" to separate the two major types of nonstock corporations.[34]

The definition of "charitable nonstock corporation" is intended to clarify references to this type of nonstock corporation that existed in the pre-amendment DGCL, prohibiting mergers that would cause the charitable status of such corporations to be lost or impaired.[35] Any potential lack of clarity caused from the omission of phrases such as "religious" or "educational" in the pre-amendment DGCL is resolved by the reference to "any nonprofit nonstock corporation that is exempt from taxation under § 501(c)(3) of the United States Internal Revenue Code."[36]

In the post-amendment DGCL, the sections prohibiting mergers that would cause the charitable status of charitable nonstock corporations to be lost or impaired have been placed consistently throughout the merger provisions and added to related provisions, such as the conversion statute.[37] Furthermore, the new definition also bolsters the post-amendment DGCL's recognition of the Attorney General's traditional oversight role[38] over charitable nonstock corporations. The Attorney General must now be notified of certain significant events involving such corporations, including appointments of custodians or receivers;[39] disso-

31. Del. Code Ann. tit. 8, § 114(d)(2) (2010).

32. *Id.* § 114(d)(3).

33. *See infra* text accompanying notes 60–69 (discussing subsection 114(c)).

34. For one specific example, subsection 114(d)(3) effectively provides that members without the right to receive dividends are forbidden by law from receiving dividends, and vice versa.

35. *See, e.g.*, Del. Code Ann. tit. 8, § 258(d) (2010). The purpose for this language is to protect against the argument that the mere power to merge with a non-charitable entity would cause a charitable nonstock corporation to lose its exempt status. A similar argument was made in *Stevens Bros. Foundation, Inc. v. Commissioner*, 324 F.2d 633, 642–46 (8th Cir. 1963).

36. Del. Code Ann. tit. 8, § 114(d)(1) (2010).

37. *See, e.g.*, *id.* §§ 253(g), 255(g), 256(g), 257(f), 258(d), 263(f), 264(f), 266(j).

38. *See* cases cited at *infra* note 106.

39. Del. Code Ann. tit. 8, § 226(c) (2010).

lutions of certain two-member corporations;[40] and transfers, domestications, or continuances.[41]

2. Subsection 114(a)—Translation

Subsection 114(a) has three important components. Each of these work together, along with subsections 114(b) and 114(c), to form the new nonstock corporation law.

First, subsection 114(a) provides that "the provisions of this chapter shall apply to nonstock corporations in the manner specified in the following paragraphs (a)(1)–(4) of [Section 114]."[42] That is, the default rule for nonstock corporations is that every provision of the DGCL applies. Any confusion that previously existed as to whether, for example, Section 145 applied to nonstock corporations is now dispelled. As a general matter, managers and members of nonstock corporations (and their advisors) can be certain whether a given provision of the DGCL applies to their corporations. No longer can a case like *Scattered*[43] deprive members or managers of such corporations of the benefits of applicable provisions; the DGCL's application to nonstock corporations is mandated by statute.

Second, subsection 114(a) modifies that general rule in two key respects: the DGCL's general application is subject to "subsections (b) and (c) of [Section 114]."[44] As will be explained further below, this exception allows the DGCL to apply to nonstock corporations only as necessary. That is, the exception ensures that only the DGCL's provisions that should apply to nonstock corporations do actually apply.

Third, paragraphs (1) through (4) of subsection 114(a) set forth the actual translations:

> (1) All references to stockholders of the corporation shall be deemed to refer to members of the corporation;
>
> (2) All references to the board of directors of the corporation shall be deemed to refer to the governing body of the corporation;[45]
>
> (3) All references to directors or to members of the board of directors of the corporation shall be deemed to refer to members of the governing body of the corporation; and

40. *Id*. § 273(c).
41. *Id*. § 390(i).
42. *Id*. § 114(a).
43. *See supra* text accompanying notes 10–12.
44. Del. Code Ann. tit. 8, § 114(a) (2010).
45. It is important to note that, while a nonstock corporation may have a governing body titled as a board of directors, it is still a "governing body" for purposes of the DGCL. Just as the Spanish *perro* and the English *dog* refer to the same animal, the nonstock "governing body" and the stock "board of directors" each refer to the group of individuals charged with managing the corporation's business and affairs pursuant to subsection 141(a) of the DGCL. *Cf*. Del. Code Ann. tit. 8, § 141(j) (2009) (setting forth, even before the 2010 amendments, the equivalence of these two phrases in the different contexts); *infra* note 100.

(4) All references to stock, capital stock, or shares thereof of a corporation authorized to issue capital stock shall be deemed to refer to memberships of a nonprofit nonstock corporation and to membership interests of any other nonstock corporation.[46]

These translations do the actual work of subsection 114(a). By these translations, the DGCL is both applied to nonstock corporations and applied in a manner that allows nonstock corporations to use the relevant provisions.

The operation of these translator provisions is relatively straightforward. For example, Section 146 provides, in full: "A corporation may agree to submit a matter to a vote of its stockholders whether or not the board of directors determines at any time subsequent to approving such matter that such matter is no longer advisable and recommends that the stockholders reject or vote against the matter."[47] After Section 114's translation, Section 146 applies to nonstock corporations as follows: "A corporation may agree to submit a matter to a vote of its **members** whether or not the **governing body** determines at any time subsequent to approving such matter that such matter is no longer advisable and recommends that the **members** reject or vote against the matter." The words in bold give effect to the translation pursuant to subsections 114(a)(1) and (a)(2). By this method, subsection 114(a) allows the DGCL—even those provisions containing terms referring to stock corporations—to apply to nonstock corporations. The provisions of the DGCL that contain no language referring exclusively to stock corporations (like Section 104) already apply to nonstock corporations by their own terms.[48]

Practitioners should be aware, however, of three specific applications of subsection 114(a) that may not appear clear on the face of the translation rules set forth in the statute: First, each of the four translator guides in subsections 114(a)(1)–(4) uses the terms "references" and "deemed to refer to," which were intended to show that the nonstock translations are concept-based, not merely word-based. Thus, some translations may not be verbatim and may require some rewording.[49] Second, each of the translator guides refers to the specific translated phrase with the limit-

46. Del. Code Ann. tit. 8, § 114(a)(1)–(4) (2010).

47. *Id.* § 146.

48. That is, general terms like "corporation" refer both to stock corporations and to nonstock corporations.

49. For example, subsection 144(a)(2) provides: "The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the stockholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the stockholders." Del. Code Ann. tit. 8, § 144(a)(2) (2010). Because "director" translates to "member of the governing body," the word "director's" is difficult to translate. As translated, this subsection could read: "The material facts as to the **governing body member's** or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the **members** entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the **members**." Similarly, it could also read (with no intended change in meaning): "The material facts as to the officer's relationship or interest **or the relationship or interest of the member of the governing body** and as to the contract or transaction are disclosed or are known to the **members** entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the

ing language "of the corporation" (such as "stockholders of the corporation").[50] Third, some provisions of the DGCL contain language linked to the terms "stock corporation" or "corporation other than a nonstock corporation."[51] In such cases, translation pursuant to subsection 114(a) would work an absurd result and therefore does not operate.[52]

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members." *See id.* § 114(a)(3). Either way, the meaning and application of the translated language should be clear.

Similarly, the first sentence of subsection 223(a)(2) reads:

> Whenever the holders of any class or classes of stock or series thereof are entitled to elect 1 or more directors by the certificate of incorporation, vacancies and newly created directorships of such class or classes or series may be filled by a majority of the directors elected by such class or classes or series thereof then in office, or by a sole remaining director so elected.

Id. § 223(a)(2).
Properly translated, it would read:

> Whenever any **class or classes or series of members** are entitled to elect 1 or more **members of the governing body** by the certificate of incorporation, vacancies and newly created **memberships on the governing body** of such class or classes or series may be filled by a majority of the **members of the governing body** elected by such class or classes or series thereof then in office, or by a sole remaining **member of the governing body** so elected.

These translations are proper because "holders of any . . . stock" is a reference to "stockholders" and would therefore be translated pursuant to subsection 114(a)(1). The word "directorship" would have to be translated under subsection 114(a)(3) to make logical sense; the closest parallel would be "membership on the governing body," though such a term is only derived implicitly, and not explicitly, from subsection 114(a)(3).

50. *Id.* § 114(a)(1)–(4). As an example, one portion of subsection 144(a) refers to a "contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest." *Id.* § 144(a). That would properly translate to refer to a "contract or transaction between a corporation and 1 or more of its **members of the governing body** or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its **members of the governing body** or officers, are *directors* or officers, or have a financial interest." The italicized word "directors" in that subsection does not translate because it does not refer to directors "of the corporation," but instead to directors of another corporation.

On the other hand, if a director of a stock corporation were to have engaged in an interested transaction with a nonstock corporation in which he or she was a member of the governing body, the translation would shift, as applicable, to correctly indicate which "corporation" was referred to. In that scenario, subsection 144(a) would be translated to refer to a "contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are **members of the governing body** or officers, or have a financial interest."

51. *See, e.g.*, *id.* §§ 102(b)(2), 102(d), 109(a), 160(a)(1), 220(b), 242(b)(4).

52. *See* Spielberg v. State, 558 A.2d 291, 293 (Del. 1989) ("[A] statute must be viewed as a whole, and literal or perceived interpretations which yield mischievous or absurd results are to be avoided."); *cf.* Coastal Barge Corp. v. Coastal Zone Indus. Control Bd. of Del., 492 A.2d 1242, 1247 (Del. 1985) ("The golden rule of statutory interpretation . . . is that unreasonableness of the result produced by one among alternative possible interpretations of a statute is reason for rejecting that interpretation in favor of another which would produce a reasonable result.").

For example, subsection 160(a)(1) provides that no corporation may:

> Purchase or redeem its own shares of capital stock for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation, except that a corporation other than a nonstock corporation may purchase or redeem out of capital any of its own shares which are entitled upon any distribution of its assets, whether by dividend or in liquidation, to a preference over another class or series

3. Subsection 114(b)—Carve-ins and Carve-outs

Subsection 114(a) provides generally that all provisions of the DGCL apply to nonstock corporations, but it is expressly subject to subsection 114(b). Subsection 114(b) serves as the mechanism by which the post-amendment DGCL molds the shape of the law applicable to nonstock corporations.

Subsection 114(b) splits the provisions of the DGCL into three categories: (1) those provisions made applicable to nonstock corporations by operation of subsection 114(a); (2) those provisions already applicable to nonstock corporations by their own terms; and (3) those provisions not made applicable to nonstock corporations by subsection 114(a).[53]

The first category of provisions was addressed in the previous discussion regarding subsection 114(a).[54]

Provisions in the second category—the provisions listed in subsection 114(b)(1)—are not translated by subsection 114(a) because they already apply specifically to nonstock corporations. Those provisions therefore need no translation (and need no further statutory enactment to make them apply to nonstock corporations). As noted above, one of the guiding principles of the 2010 nonstock amendments was to modify as little of the DGCL as possible.[55] While some of the provisions listed in subsection 114(b)(1) were amended,[56] practitioners generally may approach these provisions as they did before the amendments.

> of its stock, or, if no shares entitled to such a preference are outstanding, any of its own shares, if such shares will be retired upon their acquisition and the capital of the corporation reduced in accordance with §§ 243 and 244 of this title.

DEL. CODE ANN. tit. 8, § 160(a)(1) (2010).

Pursuant to subsection 114(a), this sentence translates as follows (for a nonstock corporation other than a nonprofit nonstock corporation):

> Purchase or redeem its own **membership interests** for cash or other property when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment of the capital of the corporation, except that a corporation other than a nonstock corporation may purchase or redeem out of capital any of its own shares which are entitled upon any distribution of its assets, whether by dividend or in liquidation, to a preference over another class or series of its stock, or, if no shares entitled to such a preference are outstanding, any of its own shares, if such shares will be retired upon their acquisition and the capital of the corporation reduced in accordance with §§ 243 and 244 of this title.

None of the other terms in subsection 160(a)(1) are translated (such as "its own shares" or "its stock") because a "corporation other than a nonstock corporation" does not have membership interests. The limiting phrase "corporation other than a nonstock corporation" was designed to resist the translation imposed by Section 114. To override that intentional limitation would violate the nonstock amendments' policy of "codifying common sense" (*see* text accompanying *supra* note 23). The post-amendment DGCL is intended to apply to nonstock corporations in a common-sense manner, not in a way that would be unexpected, absurd, or illogical.

53. DEL. CODE ANN. tit. 8, 114(b) (2010). It should be noted that some of the sections listed in subsection 114(b)(2), although they are not translated by subsection 114(a), may nonetheless be made applicable to nonstock corporations by other provisions in the DGCL. *See, e.g.*, *id.* §§ 215(a), 255(e)–(f), 276. For example, while Section 211 is listed in subsection 114(b)(2), certain provisions of Section 211 apply to nonstock corporations, as translated by subsection 215(a). *See id.* §§ 114(b)(2), 215(a).

54. *See* text accompanying *supra* notes 42–52.

55. *See* text accompanying *supra* notes 24–27.

56. *See, e.g.*, DEL. CODE ANN. tit. 8, § 215(f) (2010) (as amended by 77 Del. Laws ch. 253, § 19 (2010)).

Similarly, provisions in the third category—the provisions listed in subsections 114(b)(2)–(3)—should also be treated as they were before the amendments: generally not applicable to nonstock corporations.[57] Subsection 114(b)(3) carves out from the translator provision in subsection 114(a) two subchapters of the DGCL, Subchapter XIV (dealing with close corporations) and Subchapter XV (dealing with foreign corporations). The general intent is that those subchapters would not apply to nonstock corporations, and subsection 114(b)(3) makes that clear. Subsection 114(b)(2) lists the individual provisions of the DGCL that do not generally apply to nonstock corporations. Any provision listed in subsection 114(b)(2) does not apply to nonstock corporations, unless made applicable somewhere else in the DGCL (such as by subsection 215(a), for example).

As a general matter, all provisions of the DGCL presumptively apply to nonstock corporations. Practically speaking, the law governing nonstock corporations is made up of the provisions listed in subsection 114(b)(1) and the provisions *not* listed in subsections 114(b)(2) and 114(b)(3).[58] Use of this structure should become simple after some practice, but statutory analysis for nonstock corporations should generally take the following path:

- Is the provision listed in subsection 114(b)(1)?
  - If yes, the provision applies by its terms.
  - If no, is the provision listed in subsections 114(b)(2) or 114(b)(3)?
    - If no, does the provision contain any language specific to stock corporations?
      - If yes, the provision applies as translated by subsection 114(a) (if translation is required).
      - If no, the provision applies by its terms.
    - If yes, does another provision in the DGCL render the provision applicable and/or provide a translation mechanism?
      - If yes, the provision applies as directed by the other provision.
      - If no, the provision is not translated and does not apply.

Following that process should make it easy to determine whether a given statute applies to nonstock corporations and, if it does apply, how it applies.[59]

57. Again, some of the sections listed in subsection 114(b)(2) may be made applicable to nonstock corporations by other provisions in the DGCL. *See supra* note 53.

58. Of course, all provisions referring generically to "corporations," without any language specific to stock corporations (such as Section 104), also apply to nonstock corporations. *See supra* note 48. It should also be noted that some of the sections listed in subsection 114(b)(2), although they are not translated by subsection 114(a), may nonetheless be made applicable to nonstock corporations by other provisions in the DGCL. *See supra* note 53.

59. A few examples may be instructive. Section 215 is listed in subsection 114(b)(1); it therefore applies to nonstock corporations by its terms, without translation. Section 110 is not listed in subsections 114(b)(1), (2), or (3), and it contains language specific to stock corporations ("board of directors"); it therefore applies to nonstock corporations as translated by subsection 114(a). Section 106 is not listed in subsections 114(b)(1), (2), or (3), and it does not contain language specific to stock corporations; it therefore applies to nonstock corporations by its terms. Section 211 is listed in subsection 114(b)(2), but subsection 215(a) renders subsection 211(a) applicable to nonstock corporations;

4. Subsection 114(c)—Nonprofit Nonstock Corporations

Subsection 114(c), which applies only to nonprofit nonstock corporations,[60] operates much in the way that subsection 114(b) does. It serves to create, by translation and specific exceptions, a modified subset of the DGCL that applies only to nonprofit nonstock corporations.[61]

Delaware's version of a nonprofit corporation statute is effectively created by two principal mechanisms: (1) subsection 114(a)(4) distinguishes between memberships in nonprofit nonstock corporations and membership interests in all other nonstock corporations, and (2) subsection 114(c) acts, on top of subsection 114(b), to restrict the application of certain provisions of the DGCL to nonprofit nonstock corporations.

First, subsection 114(a)(4) makes a crucial distinction between the two major types of nonstock corporations—members of nonprofit nonstock corporations have only memberships in their corporations, while members of all other nonstock corporations own membership interests in their corporations.[62] This distinction is important because the DGCL provides that *membership interests* are personal property,[63] while *memberships* in nonprofit nonstock corporations are not personal property.[64] The distinction is also important because only *membership interests* represent a member's share of the profits and losses of a nonstock corporation, and only *membership interests* allow a member to receive distributions of the nonstock corporation's assets.[65]

This distinction becomes clear when a provision of the DGCL is translated. For example, subsection 263(b)(3) of the DGCL, addressing mergers of Delaware corporations and partnerships, provides:

> The agreement shall state: . . . the manner, if any, of converting the shares of stock of each such corporation and the partnership interests of each such partnership into shares, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation or of cancelling some or all of such shares or interests, and if any shares of any such corporation or any partnership interests of any such partnership are not to remain outstanding, to be converted solely into shares, partnership interests or other securities of the entity surviving or resulting from such

subsection 211(a) therefore applies to nonstock corporations as translated by subsection 215(a). Section 167 is listed in subsection 114(b)(2), and no other provision in the DGCL renders it applicable to nonstock corporations; it therefore does not apply to nonstock corporations.

60. Such corporations are defined in Del. Code Ann. tit. 8, § 114(d)(3) (2010).

61. *See id.* § 114(c).

62. *See id.* § 114(a)(4).

63. *Id.* § 159 (by translation under subsection 114(a)).

64. That is because subsection 114(c) provides that Section 159 does not apply to nonprofit nonstock corporations. *Id.* § 114(c)(3). Because memberships in nonprofit nonstock corporations are not personal property, they may not be transferred like personal property. Nevertheless, conditions of membership could be drafted to address this issue. For example, a member could be defined as "Acme Corporation, or its successor (whether by merger, consolidation, acquisition of all or substantially all of its assets, or otherwise)" or as "John Smith or, upon his death, any of his living heirs who, upon receipt of notice, indicate in writing their willingness to become a member within 30 days of such notice."

65. *Id.* § 114(d)(2).

> merger or consolidation or to be cancelled, the cash, property, rights or securities of any other corporation or entity which the holders of such shares or partnership interests are to receive in exchange for, or upon conversion of such shares or partnership interests and the surrender of any certificates evidencing them, which cash, property, rights or securities of any other corporation or entity may be in addition to or in lieu of shares, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation . . . .[66]

When translated for a nonprofit nonstock corporation, the same provision would read:

> The agreement shall state: . . . the manner, if any, of converting the **memberships** of each such corporation and the partnership interests of each such partnership into **memberships**, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation or of cancelling some or all of such **memberships** or interests, and if any **memberships** of any such corporation or any partnership interests of any such partnership are not to remain outstanding, to be converted solely into **memberships**, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation or to be cancelled, the cash, property, rights or securities of any other corporation or entity which the holders of such **memberships** or partnership interests are to receive in exchange for, or upon conversion of such **memberships** or partnership interests and the surrender of any certificates evidencing them, which cash, property, rights or securities of any other corporation or entity may be in addition to or in lieu of **memberships**, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation . . . .

On the other hand, when translated for any other nonstock corporation, the provision would read as follows:

> The agreement shall state: . . . the manner, if any, of converting the **membership interests** of each such corporation and the partnership interests of each such partnership into **membership interests**, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation or of cancelling some or all of such **membership interests** or [partnership] interests, and if any **membership interests** of any such corporation or any partnership interests of any such partnership are not to remain outstanding, to be converted solely into **membership interests**, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation or to be cancelled, the cash, property, rights or securities of any other corporation or entity which the holders of such **membership interests** or partnership interests are to receive in exchange for, or upon conversion of such **membership interests** or partnership interests and the surrender of any certificates evidencing them, which cash, property, rights or securities of any other corporation or entity may be in addition to or in lieu of **membership interests**, partnership interests or other securities of the entity surviving or resulting from such merger or consolidation . . . .

Second, subsection 114(c) itself creates a distinction for nonprofit nonstock corporations. Its method of operation is first to exclude from application all

66. *Id.* § 263(b)(3).

provisions of the DGCL that do not apply to any nonstock corporation. Thus, as provided in subsection 114(c)(1) (which adopts the carve-outs listed in subsection 114(b)), nonprofit nonstock corporations are not subject to the DGCL provisions that do not apply to any other nonstock corporation. Subsections 114(c)(2) and (c)(3) then exclude other specified provisions from applying to nonprofit nonstock corporations. Members of nonprofit nonstock corporations therefore are not entitled to seek appraisal,[67] and nonprofit nonstock corporations are not authorized to make distributions to their members[68] or to purchase or redeem memberships in the corporation.[69]

C. Summary of the Nonstock Amendments to the DGCL

Section 114 provides the mechanism by which most of the DGCL is applied to nonstock corporations in an as-translated fashion, but the 2010 amendments also expanded certain powers of nonstock corporations and clarified some of the substantive law applicable to them. Those amendments are described in detail below.

1. Subchapter I—Formation

The nonstock amendments wrought significant changes to Subchapter I of the DGCL, particularly in the addition of new Section 114.[70] Subsection 102(a)(4) was also amended to provide a number of enabling provisions.[71] Other changes in Subchapter I were designed to ensure that Section 114's translator provision would function as intended, and the balance of Subchapter I was generally made applicable to nonstock corporations.[72]

a. Conditions and Criteria of Membership

Some of the more significant amendments to subsection 102(a)(4) relate to the concept—unique to nonstock corporations under the DGCL—of conditions of membership. Unlike stock corporations, in which the owners are identified through their ownership of shares (which are personal property representing undivided interests in the corporation's assets), nonstock corporations have traditionally been required to identify their members through "conditions of membership." Before the 2010 amendments, subsection 102(a)(4) required nonstock

67. *Id.* § 114(c)(2).
68. *Id.* § 114(c)(3).
69. *Id.*
70. *See supra* Part II.B.
71. Section 102 of the DGCL generally deals with organizational matters that are required to be included in the certificate of incorporation. But since subsection 102(a)(4) contained crucial provisions regarding the members of nonstock corporations, the 2010 amendments used the same subsection to provide for a number of related provisions even though those provisions might logically have been located elsewhere had the 2010 amendments been written on a blank slate.
72. *But see* Del. Code Ann. tit. 8, § 114(b)(1), (c)(2) (2010) (carving out a small number of provisions in Subchapter I).

corporations to state their "conditions of membership" in their certificates of incorporation or to provide in their certificates that the conditions "shall be stated in the bylaws."[73] This requirement was amended and other enabling provisions relating to membership were also added to subsection 102(a)(4).

First, subsection 102(a)(4) no longer refers only to "conditions of membership." Nonstock corporations may now state their conditions of membership "or other criteria for identifying members."[74] This expansion in terms clarifies the flexibility provided to nonstock corporations with regard to identifying their members. The prior "conditions of membership" language seemed to contemplate civic associations and other nonprofits with membership conditionally defined by location ("members shall be all residents of Normandy Manor"), affiliation ("members shall be all Wilmington residents interested in the care and upkeep of Rockford Park"),[75] or identification ("members shall be the members of the Board of Directors"). The new "criteria" language clarifies that other practices of identifying members, such as in a document similar to a stock register, are also acceptable.

Second, subsection 102(a)(4) was amended to make clear that these conditions or criteria may be stated "in the certificate of incorporation or the bylaws."[76] This is an expansion from the prior law, which required that, if the conditions were stated in the bylaws, the certificate of incorporation had to so provide. In recognition of the fact that many nonstock corporations had failed to so provide, the 2010 amendments provided this extra flexibility.

Third, the 2010 amendments made a further change to address both a minor uncertainty under the prior law and rampant failure to follow that law. Under the pre-amendment DGCL, it was not expressly required that a nonstock corporation have members, although that was largely presumed.[77] Regardless, many nonstock corporations failed to provide, in either their certificates or their bylaws, any conditions of membership. Whether this situation was due to a failure to understand that even nonprofit nonstock corporations needed members, or a failure to notice that such a crucial requirement was tucked into the last two sentences of an otherwise inapplicable subsection of the DGCL, the 2010 amendments were intended both to clarify the law and to protect against any negative effects of that clarification.[78] After the 2010 amendments, all nonstock corporations must have

73. Del. Code Ann. tit. 8, § 102(a)(4) (2009), *amended by* 75 Del. Laws ch. 253, § 1 (2010). The other requirement in old subsection 102(a)(4)—to provide in the certificate that the corporation is not authorized to issue capital stock—remains, and was not affected by the 2010 amendments.

74. Del. Code Ann. tit. 8, § 102(a)(4) (2010).

75. *Cf*. Durney v. St. Francis Hosp., Inc., 83 A.2d 753, 755 (Del. Super. Ct. 1951) (describing the following conditions of membership: "interest and zeal in the furtherance of the charitable work for which this corporation is organized and particularly active interest in the construction and maintenance of said Hospital" (internal quotation marks omitted)).

76. Del. Code Ann. tit. 8, § 102(a)(4) (2010).

77. *See, e.g.*, Oberly v. Howard Hughes Med. Inst., 472 A.2d 366, 392 (Del. Ch. 1984) (suggesting that "the statutes require that a nonstock corporation have 'members' as opposed to shareholders" (citing Del. Code Ann. tit. 8, § 102(a)(4))).

78. The 2010 amendments recognized the importance of providing for members to which the corporation is accountable or for whose benefit the corporation operates, but they acknowledged

members, but the failure to have members will not affect otherwise valid corporate acts or work a forfeiture or dissolution of the corporation.[79]

While this may seem like a mere technical fix designed to remedy isolated and innocent statutory violations, it has several important implications. First, although the statutory violation likely arose, in many cases, from an initial oversight, it nevertheless could have been significant, calling into question the validity of almost any corporate action.[80] Before the 2010 amendments, if a nonstock corporation's certificate of incorporation had been silent regarding the conditions of membership, the corporation technically would have had no members, even if the bylaws expressly identified the members or the criteria for membership. Many of those corporations, though, undoubtedly conducted meetings of members in which the governing body was purportedly elected. Except in the case of holdovers, the members of the governing body so "elected" would not have validly been in office and would arguably have had no clear legal authority to take action on behalf of the corporation. Moreover, because changes to the conditions or criteria of membership can operate as de facto restrictions on transfer and ownership,[81] the amendments to subsection 102(a)(4) require nonstock corporations to give greater thought to the delicate balance between the certificate of incorporation and bylaws, and the provisions regulating amendments to those instruments, in identifying its members.[82]

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the practical reality that the organizational documents of many small nonstock corporations (such as homeowners' associations and local nonprofit organizations) may not have set forth their conditions of membership in strict compliance with the law and may therefore have been operating without members. The 2010 amendments therefore clarified that the actions of these corporations will not be invalidated on that basis.

79. Del. Code Ann. tit. 8, § 102(a)(4) (2010). Among other things, this language would allow the governing body to amend the certificate of incorporation or bylaws of a nonstock corporation that, for whatever reason, has lost its last remaining member. Unlike stock corporations, in which the stock is still outstanding even if a stockholder dies, the membership conditions of nonstock corporations can result in a failure to have members. For example, a nonstock corporation could identify its members as "all residents of the building located at 1185 Commonwealth Avenue." If the building somehow became uninhabited, the corporation would not dissolve, and the governing body of that corporation could take further steps as necessary.

80. *Cf*. Read v. Tidewater Coal Exch., Inc., 116 A. 898, 906 (Del. Ch. 1922) ("[T]he corporate existence of this corporation cannot be successfully questioned in this proceeding, because of an omission to set out in more detail the conditions of membership therein, for the reason, as above stated, that it undoubtedly has at the least a de facto existence.").

81. *See infra* Part II.C.6.

82. As described in greater detail below, as is the case with stock corporations, the bylaws generally may be amended by the members of a nonstock corporation or by the governing body, but, unlike for stock corporations, a nonstock corporation's certificate of incorporation may be amended solely by its governing body, without a further vote of members unless the certificate expressly provides otherwise. Del. Code Ann. tit. 8, § 242(b)(3) (2010). If the certificate of incorporation and the bylaws conflict, the provisions of the certificate of incorporation will control. *Id*. § 109(b) ("The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."). Thus, whether a nonstock corporation elects to set forth its conditions or criteria of membership either in the certificate of incorporation or in the bylaws, it should also consider the need to impose limitations on the power of the governing body or the members to amend those conditions and should understand that the manner in which those

Finally, and largely for the reasons just noted, the 2010 amendments introduced a "gap filler" in subsection 102(a)(4) ensuring that nonstock corporations failing to include conditions of membership in their certificate of incorporation or the bylaws will nonetheless have members. In those cases, the members will be "deemed to be those entitled to vote for the election of the members of the governing body pursuant to the certificate of incorporation or bylaws of such corporation or otherwise."[83] The "otherwise" language was designed to assist, for example, a homeowners' association that failed to include conditions of membership in its organizational documents but has—by custom or practice, or through some other authority, such as the terms of a deed—extended to each resident in the neighborhood the right to vote in elections of the corporation's governing body. Under the gap filler, those residents are now deemed to be the corporation's members. That gap filler remains operative only until such time as the corporation amends its certificate of incorporation or bylaws to provide the conditions or criteria of membership in compliance with subsection 102(a)(4).[84]

b. Classes and Voting Rights

The scant language in the pre-amendment subsection 102(a)(4) relating to nonstock corporations stood in stark contrast to the detailed provisions of that subsection relating to stock corporations and the creation of multiple classes of stock with various rights, powers, and preferences. Thus, while a nonstock corporation had the authority to state its "conditions of membership" before the 2010 amendments, it did not have express statutory authority to provide for multiple classes of members or membership interests,[85] nor the express statutory authority to ascribe different rights and powers to those members or holders of membership interests.[86] The 2010 amendments address these deficiencies.

The amendments to subsection 102(a)(4) make clear that nonstock corporations may create different classes of members.[87] As part of the flexibility built into

limitations may be imposed is different than it would be in the case of a stock corporation. Without the proper limitation on amendments to the conditions or criteria of membership, members of a nonstock corporation subject themselves to changes to the terms of their membership interests, or to being divested of their membership, at the sole discretion of the governing body. *But cf.* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (stating that "inequitable action does not become permissible simply because it is legally possible").

83. Del. Code Ann. tit. 8, § 102(a)(4) (2010).

84. *Id.*

85. That said, the pre-amendment DGCL did include some language suggesting that nonstock corporations could provide for different classes of members and membership interests. *See, e.g.*, Del. Code Ann. tit. 8, § 242(b)(3) (2009) (referring to "the members or . . . any specified class of members"); *id.* § 257(b) (referring to the conversion of shares in a merger into "voting or nonvoting regular, life, general, special or other type of membership" in a nonstock corporation).

86. *See id.* § 102(a)(4).

87. Del. Code Ann. tit. 8, § 102(a)(4) (2010) ("Nonstock corporations may provide for classes or groups of members having relative rights, powers and duties, and may make provision for the future creation of additional classes or groups of members having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of members.").

the 2010 amendments, provisions creating classes of members may be set forth in the corporation's certificate or its bylaws.[88] A nonstock corporation may also, unless otherwise provided in the DGCL, provide in its certificate of incorporation or bylaws that:

> [A]ny member or class or group of members shall have full, limited, or no voting rights or powers, including that any member or class or group of members shall have the right to vote on a specified transaction even if that member or class or group of members does not have the right to vote for the election of the members of the governing body of the corporation.[89]

Voting by members of a nonstock corporation may also, as set forth in the corporation's certificate or bylaws, be on "a per capita, number, financial interest, class, group, or any other basis set forth."[90] Again, the 2010 amendments were intended to provide maximum flexibility and expressly contemplated, among other things, non-voting members. For example, a museum may have voting members who elect the members of the governing body (indeed, they may be the members of the governing body themselves), and it may have non-voting members who pay annual membership fees but do not get to vote on any corporate matter. Also, and particularly useful in the for-profit context, these voting provisions were designed to be as flexible as, and were based on, Delaware's Limited Liability Company Act.[91]

c. Optional Provisions in the Certificate of Incorporation

The 2010 amendments also made some changes to subsection 102(b) of the DGCL, which sets forth the various provisions that a corporation may include in its certificate of incorporation. With one exception, however, those changes were largely technical changes intended to ensure the application of those provisions either by their own terms (subsection 102(b)(1)) or by application of Section 114 (subsections 102(b)(6) and (b)(7)).

The one exception is the addition of specific language relating to nonstock corporations in the "compromise" provision included in subsection 102(b)(2). Before the 2010 amendments, subsection 102(b)(2) provided that a corporation could include in its certificate of incorporation a provision specifying that any creditor or stockholder of the corporation, or its receiver, may apply to the Delaware Court of Chancery for an order directing a meeting of the creditors of the corporation to

88. *Id.*

89. *Id.* The right to vote in the election of members of the governing body is the default voting right, and members with that right have the right to vote on all major transactions. *See, e.g.*, *id.* §§ 255(c), 271(a). This language in subsection 102(a)(4) allows a nonstock corporation to give voting rights to other members.

90. *Id.* § 102(a)(4).

91. *Compare, e.g.*, *id.* ("Voting by members of a nonstock corporation may be on a per capita, number, financial interest, class, group, or any other basis set forth."), *with* Del. Code Ann. tit. 6, § 18-302(b) (2010) ("Voting by members may be on a per capita, number, financial interest, class, group or any other basis.").

consider any proposed compromise between such creditors and the corporation, so long as it included that provision, *in haec verba*, in its certificate of incorporation.[92] Because one clear mandate of subsection 102(b)(2) was that the compromise provision had to be included *in haec verba*, the provision could not have been available to nonstock corporations. That is, a nonstock corporation including the language would have imported the inapplicable term "stockholder," while a nonstock corporation changing the term "stockholder" to "member" would have violated the statutory requirement of *in haec verba*.[93] To eliminate such confusion in the future, the 2010 amendments provided nonstock corporations with their own verbiage.[94]

d. Bylaws

In the 2010 amendments, subsection 109(a) was reworded for clarity, but no substantive changes were intended. The application of Section 114 to subsection 109(b),[95] however, addresses a minor lack of clarity in the pre-amendment DGCL. That is, the pre-amendment 109(a) expressly included language regarding nonstock corporations.[96] But the pre-amendment 109(b) did not, arguably rendering subsection 109(b) inapplicable to nonstock corporations.[97] Regardless of the latent confusion in the pre-amendment law, the 2010 amendments made clear that Section 109 applies in its entirety to nonstock corporations.

e. Jurisdiction

No changes were made to Section 111 of the DGCL in the 2010 amendments. But two subsections (111(a)(2) and (a)(3)) were carved out of the law applicable to nonprofit nonstock corporations[98] because such corporations may not sell their memberships ((a)(2)) or impose written transfer restrictions on their memberships under Section 202 of the DGCL ((a)(3)).

2. Subchapter II—Powers

No changes were made to any provisions in Subchapter II of the DGCL, which is made applicable through Section 114's translator provision to both for-profit and nonprofit nonstock corporations. But two specific effects of the 2010 amendments are worth noting.

First, the 2010 amendments clarified that certain of the specific powers listed in Section 122 using stock-corporation terms are available to nonstock cor-

92. *See* Del. Code Ann. tit. 8, § 102(b)(2) (2009), *amended by* 77 Del. Laws ch. 253, §§ 3–4 (2010).

93. Literally, "in these words," but generally read to mean "in these exact words."

94. *See* Del. Code Ann. tit. 8, § 102(b)(2)(ii) (2010).

95. *Cf. id.* § 114(b)(1) (carving out subsection 109(a), but not subsection 109(b), from the translation provision in subsection 114(a)).

96. Del. Code Ann. tit. 8, § 109(a) (2009), *amended by* 77 Del. Laws ch. 253, § 8 (2010).

97. *Id.* § 109(b); *see also* text accompanying *supra* notes 9–15.

98. Del. Code Ann. tit. 8, § 114(c)(2) (2010).

porations. Among these are important specific powers, such as the power to "[t]ransact any lawful business" in aid of governmental authority[99] (referring specifically to a "board of directors"[100]), the power to make intra-enterprise guarantees (referring to "stock"),[101] and the power to renounce certain classes or categories of business interests (referring to a "board of directors," "directors," and "stockholders").[102] The 2010 amendments also clarified—to the extent that it required clarification[103]—that Section 121 applies to nonstock corporations. One consequence of this aspect of the 2010 amendments is that, regarding the empowering provisions of the DGCL that apply to nonstock corporations—either by their express terms or through operation of Section 114—it is clear that nonstock corporations are not only entitled to exercise those powers, but are also subject to the restrictions.[104]

Second, the 2010 amendments clarified that Section 124 applies to nonstock corporations. Subsection 124(1) refers to a specific category of derivative suits.[105] It should be noted, however, that—even though Section 124 applies to nonprofit nonstock corporations—the 2010 amendments did not affirmatively grant to members of nonprofit or charitable nonstock corporations any right to sue derivatively.[106] Such a right is an equitable right granted by the courts,[107] and Section 114's application to Section 124 should not be considered an indication of whether members of nonprofit nonstock corporations have such a right.

3. Subchapter III—Registered Office and Registered Agent

No changes were made to Subchapter III of the DGCL in the 2010 amendments, and all provisions of Subchapter III apply to all nonstock corporations.

99. *Id.* § 122(12).

100. As noted at *supra* note 45, a nonstock corporation—regardless of what term it uses (board of directors, board of managers, board of trustees, management committee, etc.)—technically does not have a board of directors; it has a governing body. Before the 2010 amendments, as a pure matter of statutory interpretation, the specific power set forth in subsection 122(12) arguably referred only to stock corporations.

101. Del. Code Ann. tit. 8, § 122(13) (2010).

102. *Id.* § 122(17).

103. As a matter of statutory interpretation, *see* text accompanying *supra* notes 9–15, it could reasonably be argued that Section 121 (referring to "directors and stockholders") did not apply to nonstock corporations before the 2010 amendments. We believe that the 2010 amendments mooted any such argument and served to confirm, if necessary, that Section 121 applies fully to all nonstock corporations.

104. Subsection 121(b) provides that every corporation "shall be governed by the provisions and be subject to the restrictions and liabilities contained in this chapter." Del. Code Ann. tit. 8, § 121(b) (2010).

105. *See id.* § 124(1) (permitting derivative suits to enjoin ultra vires acts).

106. Certain cases suggest that the Attorney General's power to bring suit on behalf of a charitable corporation is exclusive. *See* Wier v. Howard Hughes Med. Inst., 407 A.2d 1051, 1057 (Del. Ch. 1979); *see also* Oberly v. Kirby, 592 A.2d 445, 468 (Del. 1991); Wier v. Howard Hughes Med. Inst., 404 A.2d 140, 145 (Del. Ch. 1979); Pollock v. Peterson, 271 A.2d 45, 49 (Del. Ch. 1970).

107. *See* Schoon v. Smith, 953 A.2d 196, 204 (Del. 2008) (noting that Section 327 is a *restriction* on this right—not an affirmative grant of the right).

4. Subchapter IV—Directors and Officers

The 2010 amendments made only technical changes to Subchapter IV of the DGCL, but several aspects and consequences of the 2010 amendments are worth noting. With two exceptions noted below, all the provisions in Subchapter IV are made applicable to nonstock corporations by Section 114.

At the outset, it should be made clear that the 2010 amendments were intended to have no effect on the fiduciary duties of members of nonstock corporations' governing bodies. Nor should the 2010 amendments be interpreted to change, in any way, the nature of fiduciary duties owed by members of the governing bodies of nonstock corporations—either of for-profit nonstock corporations or nonprofit nonstock corporations.[108]

It is important that Section 141 of the DGCL—the provision that grants the board of directors the authority to manage the business and affairs of the corporation and deals broadly with the composition, structure, and functioning of the board—is not translated by Section 114. Subsection 141(j) already contained provisions applicable to nonstock corporations (as well as its own "translator" provision), and it had been in place for many years.[109] The 2010 amendments therefore carved Section 141 out of Section 114's translator,[110] and made only minor changes to subsections 141(j) and (k). Subsection 141(j), which has long provided nonstock corporations with wide-ranging flexibility in arranging the management of their business and affairs, was amended solely to make its internal translator mechanism consistent with that in subsection 114(a).[111] Technical amendments to subsection 141(k) were also made for consistency.[112]

No specific changes were made to Section 142, which deals with the selection, duties, and terms of officers, but the 2010 amendments clarified that Section 142 applies to nonstock corporations.[113] Notably, by virtue of such application, nonstock corporations must have an officer charged with the duty of recording the proceedings of all meetings of the corporation's members.[114]

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108. *See Oberly*, 592 A.2d at 461–62 (holding that corporate fiduciary principles, not trust fiduciary principles, apply to nonprofit and charitable nonstock corporations). *But cf. id.* at 458 (noting that the duties of members of governing bodies of charitable nonstock corporations run to the corporations' beneficiaries, not to their members).

109. *See* text accompanying *supra* note 8.

110. Del. Code Ann. tit. 8, § 114(b)(1) (2010).

111. One effect of this change was to clarify that the provisions of subsection 141(d) (relating to provisions of the certificate of incorporation conferring upon separate classes or series of stock the power to elect one or more directors) and subsection 141(k) (relating to the removal of directors by holders of a majority of the shares then entitled to vote at an election of directors, or by the holders of any class or series of stock) apply to nonstock corporations in the manner provided by the translator in subsection 141(j).

112. Also, the unduly restrictive word "nonprofit" in the title of Section 141 was changed to "nonstock." 77 Del. Laws ch. 253, § 10 (2010).

113. *See* Del. Code Ann. tit. 8, § 114 (2010).

114. *Id.* § 142(a). Of course, since nonstock corporations need not hold annual member meetings, this should not have the practical effect of imposing an obligation that did not exist heretofore. *See also id.* § 142(d) ("A failure to elect officers shall not dissolve or otherwise affect the corporation.").

The 2010 amendments effected minor technical changes to Section 144 of the DGCL to ensure the proper application of Section 114's translator mechanism. Section 144 provides three specific procedures by which certain "interested" contracts or transactions involving the corporation and its officers and directors may be insulated against a finding that they are void or voidable.[115] Generally speaking, those procedures include approval of the contract or transaction by a majority of the disinterested directors (subsection 144(a)(1)), approval of the contract or transaction by a majority of the disinterested stockholders (subsection 144(a)(2)),[116] or a judicial finding that the contract is fair to the corporation at the time it is authorized (subsection 144(a)(3)).

The 2010 amendments also made clear that the "safe harbor" procedure in subsection 144(a)(2) does not apply to nonprofit nonstock corporations.[117] That is, interested transactions involving nonprofit nonstock corporations may not be placed in Section 144's safe harbor by a majority vote of the corporations' members. This aspect of the 2010 amendments comports with the Delaware Supreme Court's decision in *Oberly v. Kirby*, in which the court held that, while Section 144's principles could generally be applied to a charitable nonstock corporation, subsection 144(a)(2) could not because such a corporation is not managed for the benefit of its members.[118]

5. Subchapter V—Stock and Dividends

Only a few changes were made to Subchapter V of the DCGL in the 2010 amendments. Furthermore, no provision in Subchapter V applies to any nonprofit nonstock corporation, and fewer than half apply to for-profit nonstock corporations.[119]

The key defining feature of all nonstock corporations, and the one that distinguishes those corporations from their stock counterparts, is that they are not authorized to issue capital stock. For this reason, many of the provisions of Sub-

115. *See generally* Blake Rohrbacher, John Mark Zeberkiewicz & Thomas A. Uebler, *Finding Safe Harbor: Clarifying the Limited Application of Section 144*, 33 Del. J. Corp. L. 719 (2008) (discussing Section 144, its history, and its application).

116. While Section 144 itself contains no requirement that the stockholders be disinterested, *see id*. at 731–32, it has been so interpreted, *see id*. at 741 n.101; Gantler v. Stephens, 965 A.2d 695, 713 n.54 (Del. 2009) (referring to the Delaware Supreme Court's "jurisprudence governing the effect of an approving vote of disinterested shareholders under 8 *Del. C*. § 144").

117. Del. Code Ann. tit. 8, § 114(c)(2) (2010).

118. 592 A.2d 445, 467 (Del. 1991) ("Since a for-profit corporation is to be managed for the benefit of its stockholders, the statute sets out the conditions under which stockholders may assert that the directors have acted in their own interests rather those of the stockholders. The Foundation, however, must be managed on behalf of its beneficiaries, who are represented by the Attorney General. Since the statute does not address the roles of the beneficiaries or the Attorney General in challenging the conduct of the directors of charitable corporations, we cannot apply it directly to the Foundation."). Furthermore, since stockholders (and members of a for-profit nonstock corporation) have a financial interest in the corporation, their "skin in the game" should allow them, as a policy matter, to approve interested transactions. The members of nonprofit nonstock corporations have no such "skin in the game."

119. Del. Code Ann. tit. 8, § 114(b)(2), (c)(3) (2010).

chapter V relating to the creation and issuance of capital stock do not—by logic but also by definition—apply to nonstock corporations. That said, although it was often presumed that nonstock corporations would be organized as not-for-profit corporations,[120] no provision in the DGCL compelled such a conclusion. As a result, many for-profit corporations took advantage of the nonstock structure.[121] That the DGCL, as initially drafted, did not contemplate for-profit nonstock corporations is evident in the pre-amendment gaps in the various provisions of Subchapter V.[122]

The 2010 amendments sought to bring clarity to this entire area of the law and, in so doing, gave the DGCL an operative framework to distinguish between for-profit and nonprofit corporations and to specify the powers and limitations of each. In short, the 2010 amendments applied the relevant provisions of Subchapter V—provisions for dealing in the corporation's membership interests and declaring and paying dividends thereon—to for-profit nonstock corporations, while providing that Subchapter V does not apply at all to nonprofit nonstock corporations (i.e., those corporations that, by definition, do not have membership interests in which they may deal or on which they may declare and pay dividends). To implement this structure, the 2010 amendments effected a few amendments to the relevant provisions of Subchapter V.

Normally, when a corporation seeks to determine whether it has funds lawfully available to repurchase its shares or to declare or pay dividends, it must determine the amount of the corporation's "capital," which for stock corporations is derived by reference to its shares of capital stock. Since nonstock corporations—by definition—are not authorized to issue capital stock,[123] this determination posed somewhat of a problem. The 2010 amendments added a sentence to Section 154 to clarify that the "capital of any nonstock corporation shall be deemed to be zero."[124]

The amendment to Section 154 allowed a complementary amendment to Section 160, to permit for-profit nonstock corporations to purchase or redeem their membership interests for cash.[125] Subsection 160(a)(3) was also amended to address a technical issue regarding the redemption of membership interests. Before the 2010 amendments, Section 160 provided that a corporation could not redeem

120. *See supra* note 7.

121. Historically, many of the principal stock exchanges were organized as nonstock corporations. *See, e.g.*, *In re* Phila. Stock Exch., Inc., 945 A.2d 1123, 1130 (Del. 2008); Scattered Corp. v. Chi. Stock Exch., Inc., 671 A.2d 874, 875 (Del. Ch. 1994). In addition, corporations such as Visa and Mastercard, which were composed of their member banks, until relatively recently were also organized as nonstock corporations.

122. For example, even though the 1974 and 1987 amendments to the DGCL clarified that nonstock corporations could be operated for profit, Section 170, which provides Delaware corporations with the power to declare and pay dividends, did not mention nonstock corporations until 1990. *See* S.B. 467, 135th Gen. Assem. (Del. 1990).

123. Del. Code Ann. tit. 8, § 102(a)(4) (2010).

124. *Id.* § 154.

125. *Id.* § 160(a)(1). Since a nonstock corporation's capital is deemed to be zero, it cannot be impaired.

its shares unless their redemption was authorized by Section 151 (the provision relating to the expression, in the certificate of incorporation, of the rights, powers, and preferences of capital stock) and then only in accordance with Section 151 and the certificate of incorporation.[126] Because the rights, powers, and preferences of membership interests of nonstock corporations are not required to be expressed in the certificate of incorporation under Section 151 (which does not apply to any nonstock corporation), but are instead fixed pursuant to subsection 102(a)(4), the terms of Section 160 required a technical amendment to provide that membership interests could be redeemed only if the certificate of incorporation so provided and then only in accordance with the certificate of incorporation.[127]

Section 170 was also amended, but those amendments were largely technical changes to allow Section 114's translator provision to operate (with regard to for-profit nonstock corporations).[128] Because Section 154 now deems the capital of a nonstock corporation to be zero, nonstock corporations (other than non-profit nonstock corporations) may pay dividends out of deemed surplus (i.e., net assets) or may pay nimble dividends (i.e., out of net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year). Because Sections 171 through 174 relate to dividends and redemption, the 2010 amendments provided that those sections apply to for-profit nonstock corporations pursuant to Section 114's translator provision.

The 2010 amendments also ensured that Section 157—with the exception of subsection 157(d), having to do with "par value" and consideration for no-par capital stock, concepts foreign to nonstock corporations—applies to for-profit nonstock corporations.[129] The 2010 amendments thereby clarified that for-profit nonstock corporations may create and issue rights and options regarding membership interests.

Finally, a significant aspect of the 2010 amendments regarding Subchapter V is the application (by translation) of Section 159 to for-profit nonstock corporations. By that amendment, the DGCL provides that members of nonprofit nonstock corporations have only memberships in their corporations, while members of for-profit nonstock corporations own membership interests in their corporations. In other words, the *membership interests* in for-profit nonstock corporations are

126. *See* Del. Code Ann. tit. 8, § 160(a)(3) (2009), *amended by* 77 Del. Laws ch. 253, § 17 (2010).

127. *See* Del. Code Ann. tit. 8, § 160(a)(3) (2010).

128. The 2010 amendments created a self-sealing definitional structure (a nonstock corporation without power to issue dividends is by definition a nonprofit nonstock corporation, which is precluded by law from paying dividends). While Section 170 was amended in 1999 to allow nonprofits to pay dividends, *see* S.B. 137, 140th Gen. Assem. (Del. 1999), the 2010 amendments prohibit nonprofit nonstock corporations from paying dividends under Section 170. Del. Code Ann. tit. 8, § 114(c)(3) (2010). Nevertheless, we believe it would be possible, if necessary, for a nonstock corporation operated not for profit to define its "membership interests" in such a way as to allow distributions of certain assets, yet retain a not-for-profit organizational structure, qualify as an "exempt corporation" under Delaware law, and qualify as a tax-exempt organization under federal law. *See id.* §§ 114(d)(2), 501(b)(6); I.R.C. § 501(c)(7) (2006).

129. Del. Code Ann. tit. 8, § 114(b)(2) (2010).

personal property,[130] while the *memberships* in nonprofit nonstock corporations are not personal property.[131]

6. Subchapter VI—Stock Transfers

The 2010 amendments made no changes to the provisions in Subchapter VI of the DGCL. While none of the provisions in Subchapter VI apply to nonprofit nonstock corporations, Sections 201 and 202 (but not 203) apply to for-profit nonstock corporations.[132]

Sections 201 and 202 generally provide that stock transfers shall be governed by Article 8 of the Delaware U.C.C.[133] and authorize corporations to impose restrictions on transfer and ownership, respectively. Thus, membership interests are treated the same as shares of capital stock for purposes of transfer, and membership interests may be made subject to restrictions on transfer and ownership pursuant to Section 202, subject to the limitations set forth therein. Although Section 202 empowers a for-profit nonstock corporation to impose restrictions on the transfer and ownership of its membership interests, it is not the exclusive means by which such restrictions may be implemented.

As indicated above, a nonstock corporation can determine the identity of its members by reference to the conditions or criteria of membership included in its certificate of incorporation or bylaws. As a result, a nonstock corporation may effectively impose restrictions on the transfer and ownership of its membership interests, or may restrict who may become a member without regard to Section 202, through the adoption of carefully drafted provisions in its certificate of incorporation and bylaws. In almost every way, these de facto restrictions on transfer and ownership are more effective than similar restrictions adopted under the auspices of Section 202, in large part because (subject to equitable limitations[134]) they can be made applicable to all members or holders of membership interests, regardless of whether those holders voted in favor of the restriction. Section 202, by contrast, provides that the restrictions imposed under its terms are not "binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restrictions."[135]

Under the 2010 amendments, Section 203 does not apply to any nonstock corporation.[136] Its application would be unnecessary for several reasons. Section 203 is generally viewed as Delaware's anti-takeover statute. There appears to be no

130. *Id.* § 159 (by translation under subsection 114(a)).

131. *See id.* § 114(c)(3) (providing that Section 159 does not apply to nonprofit nonstock corporations).

132. *Id.* § 114(b)(2), (c)(3).

133. *Cf.* Del. Code Ann. tit. 6, § 8-103(a) (2010) (referring to a "share or similar equity interest issued by a corporation").

134. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (stating that "inequitable action does not become permissible simply because it is legally possible").

135. Del. Code Ann. tit. 8, § 202(b) (2010).

136. *See id.* § 114(b)(2).

present need for such a statute for nonstock corporations,[137] and (as noted above) the conditions and criteria of membership can effectively prevent takeovers as well as or better than Section 203. Furthermore, though not exclusive to public companies, Section 203 generally applies only to such companies; in fact, it operates in large part to deter creeping public stock acquisitions and two-tiered, front-loaded abusive takeovers. The lack of a public market for membership interests renders inapplicable many of the concerns Section 203 was intended to address.[138]

7. Subchapter VII—Meetings, Elections, Voting, and Notice

The 2010 amendments wrought several changes to provisions in Subchapter VII, which applies to nonstock corporations in a number of important ways.

For years,[139] Section 215 of the DGCL has been one of the few provisions of the DGCL expressly governing the internal affairs of nonstock corporations; it addresses meetings and voting issues.[140] Subsection 215(a) renders inapplicable to nonstock corporations nearly all the stock-corporation provisions regarding meetings and voting (Sections 211 through 214, and Section 216), but it contains its own translator provision for the few provisions that do apply to nonstock corporations.[141] Before the 2010 amendments, subsection 215(a) adopted—through translation—three provisions: subsection 211(a) (determining the place, if any, of meetings), subsection 212(c) (authorizing the granting of proxies), and subsection 212(d) (authorizing copies of a proxy to be substituted for the original writing).[142]

In the 2010 amendments, Section 215 was amended in several notable respects.[143] As a technical matter, the translator provision in subsection 215(a) was amended to correspond to the translator provision in Section 114.[144] Then, subsections 211(d) and 211(e), which empower nonstock corporations to call special meetings of members and allow for the creation of irrevocable proxies, respectively, were added to the list of provisions translated by subsection 215(a).

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137. Of the hostile tender offers launched in the past five years for which public data is available, not one involved a nonstock corporation.

138. *See* Del. Code Ann. tit. 8, § 203(b)(4) (2010).

139. *See* 35 Del. Laws ch. 85, § 9 (1927).

140. *See* Del. Code Ann. tit. 8, § 215 (2010).

141. *Id.* § 215(a).

142. Del. Code Ann. tit. 8, § 215(a) (2009).

143. Because Section 215 had long been an important provision for nonstock corporations, and because its rules had become incorporated in many nonstock corporations' organizational documents, the 2010 amendments retained the basic structure of Section 215, making only technical or enabling amendments.

144. Thus, in addition to translating "stockholders" and "board of directors" to "members" and "governing body" of a nonstock corporation, respectively, Section 215's translator provision now provides that "all references to stock, capital stock, or shares thereof shall be deemed to refer to memberships of a nonprofit nonstock corporation and to membership interests of any other nonstock corporation." Del. Code Ann. tit. 8, § 215 (2010); *see also id.* § 114(a)(4). This is quite similar to the amendment to subsection 141(j). *See* text accompanying *supra* note 111.

As noted above, subsection 102(a)(4) was amended to provide nonstock corporations with the express authority to create multiple classes of members and membership interests and to give such corporations maximum flexibility in structuring the voting powers applicable to those classes, including by setting forth those rights in either the certificate of incorporation or the bylaws. Consistent with that amendment, subsection 215(b) was also amended to specify that, unless otherwise provided in the certificate of incorporation *or bylaws*, members are entitled to one vote on each matter submitted to a vote of members.[145] Subsection 215(b) was further amended to reflect the addition of new subsection 215(f), which provides a method for determining a record date for nonstock corporations.[146] Subsection 215(b), as amended, therefore provides that members' voting rights are subject to the record date for any particular meeting.

Also consistent with the amendments to subsection 102(a)(4), the 2010 amendments added new subsection 215(c)(4), which defines the default quorum and vote necessary to take action for separate votes of classes or groups of members.[147] Subsection 215(c)(4) provides as a default that, where a separate vote by a class or group or classes or groups is required, a *majority* of the members of such class or group or classes or groups is required to establish a quorum, and that, in all matters other than the election of members of the governing body, the affirmative vote of the majority of the members of such class or group or classes or groups present in person or represented by proxy at the meeting shall be the act of such class or group or classes or groups. It should be noted that the default quorum for required class votes is a majority of the class, even though the quorum for member meetings generally is only one-third of the members.[148] The new provision was modeled after subsection 216(4) of the DGCL, which applies a similar default quorum and voting requirement in the case of separate votes by a class or series of stock.[149] The 2010 amendments adopted the majority default quorum, instead of the one-third quorum, for several reasons. First, subsection 215(c)(4) only comes into play if a class vote is *required;* the majority quorum therefore provides the minimum critical mass necessary for a meaningful separate vote. Second, the one-third quorum provided for member meetings generally[150] is not necessarily a persuasive precedent, considering that no annual member meetings are required under the DGCL[151] and considering that the one-third requirement is designed to account for nonprofit nonstock corporations with members who have no economic stake in the enterprise.[152] Third, the 2010 amendments provided sufficient flexibility by allowing the default quorum and voting requirements set forth in subsection 215(c)(4)—as with all the other default quorum and voting

145. *See* Del. Code Ann. tit. 8, § 215(b) (2010).
146. *See id.* § 215(f).
147. *See id.* § 215(c)(4).
148. *Compare id.* § 215(c)(4), *with id.* § 215(c)(1).
149. *Id.* § 216(4).
150. *Id.* § 215(c)(1).
151. *See id.* § 215(a).
152. *Cf. infra* note 171.

requirements in subsection 215(c)—to be altered in the corporation's certificate of incorporation or bylaws.

Further, as indicated above, the 2010 amendments introduced a statutory mechanism for determining a record date for nonstock corporations. New subsection 215(f) provides that—except as otherwise provided in the corporation's certificate of incorporation, in the corporation's bylaws, or by resolution of the corporation's governing body—the record date for meetings of nonstock corporations shall be deemed to be the date of the meeting.[153] If the governing body fixes a record date, however, the record date may not precede the governing body's action fixing that record date.[154] Thus, the formal procedures set forth in Section 213 for stock corporations are unnecessary for nonstock corporations, although nonstock corporations now have the flexibility to provide for such procedures as are necessary and appropriate for their circumstances. Practically speaking, under new subsection 215(f), governing bodies of nonstock corporations need not specifically define a record date if they intend the record date to be the date of the meeting.[155]

No changes were made to Sections 217 or 218, but both sections were made generally applicable to nonstock corporations through Section 114's translator provision. Section 217 does not apply to nonprofit nonstock corporations,[156] however, so only for-profit nonstock corporations may allow fiduciaries to vote on behalf of members. Similarly, subsections 218(a) and 218(b) do not apply to nonprofit nonstock corporations.[157] While members of all nonstock corporations may enter into voting agreements, only members of for-profit nonstock corporations may enter into voting trusts (since members of nonprofit nonstock corporations do not have property interests in their memberships and thus have no property to put into such a trust).

Section 219 was made inapplicable to nonstock corporations, since such corporations are not required to maintain lists of their members.[158] Technical changes were made to Section 220 so that it applies to nonstock corporations properly under Section 114's translator provision.[159]

Section 222, regarding notice of meetings, was made inapplicable to nonstock corporations to avoid imposing notice requirements on nonstock corporations

153. Del. Code Ann. tit. 8, § 215(f) (2010). This default record date differs from the default record date for stock corporations. Pursuant to subsection 213(a), if the board of a stock corporation does not set a record date, the record date is the date that notice is given to the stockholders (or, if notice is waived, the day next preceding the day of the meeting). *Id.* § 213(a). Section 213 is expressly made inapplicable to nonstock corporations by Section 215, and nonstock corporations are not required to provide notice under the DGCL. *See id.* § 215(a); text accompanying *infra* notes 160–63.

154. Del. Code Ann. tit. 8, § 215(f) (2010).

155. Governing bodies may wish to set a specific record date in certain circumstances, for example, in the payment of a dividend.

156. Del. Code Ann. tit. 8, § 114(c)(2) (2010).

157. *Id.*

158. *Id.* § 114(b)(2). It should be noted, however, that if such a corporation *does* maintain a member list, that member list should be made available to the members pursuant to subsection 220(b)(1).

159. *See* 77 Del. Laws ch. 253, §§ 20–23 (2010).

that may not have previously applied.[160] Nonstock corporations are not required to hold annual member meetings,[161] so imposing a notice requirement for such meetings would be somewhat out of place. (Section 231, governing voting procedures and election inspectors, was made inapplicable to nonstock corporations for similar reasons.) Moreover, it is expected that nonstock corporations that require member meetings would already have provisions governing notice in their bylaws or certificates of incorporation,[162] and any inequitable conduct could be invalidated by the Delaware courts.[163] Accordingly, to provide for nonstock corporations with notice provisions in their bylaws or certificates of incorporation, Sections 229, 232, and 233 were made applicable (after technical changes to Sections 232 and 233) to nonstock corporations by translation. Subsection 230(b) already applied to nonstock corporations,[164] but the remainder of Section 230 was made applicable to nonstock corporations by translation as well. Section 228, dealing with member actions by written consent, already applied to nonstock corporations and therefore is not translated by Section 114.[165]

Minor changes were made to other provisions regarding elections and members of nonstock governing bodies. Technical changes were made to Sections 223 (vacancies and newly created memberships on the governing body) and 227 (powers of the Court in elections of the governing body)—with no intent to change the meaning or operation of those sections—so that Section 114's translator provision could apply. Similar technical changes were made to Section 225, with one result that was unclear under the pre-amendment law. Before the 2010 amendments, Section 225 allowed directors of stock corporations—but arguably not members of the governing bodies of nonstock corporations—to bring suit under subsection 225(a) to hear and determine the validity of their elections.[166] The 2010 amendments made clear that members of the governing bodies of nonstock corporations may bring such suits.[167]

Finally, Section 226, governing the appointment of a custodian or receiver for a corporation upon a deadlock or abandonment of the corporation's business, applies to nonstock corporations pursuant to the translator provision in Section 114. A new subsection 226(c) was added, applicable only to charitable

160. *See* text accompanying *supra* note 13.

161. *See* Del. Code Ann. tit. 8, § 215(a) (2010).

162. For which Section 222 could likely apply by analogy. *See* Farahpour v. DCX, Inc., 635 A.2d 894, 900 (Del. 1994).

163. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971) (stating that "inequitable action does not become permissible simply because it is legally possible").

164. *See* Del. Code Ann. tit. 8, § 230(b) (2009); *see also* Del. Code Ann. tit. 8, § 114(b)(1) (2010).

165. Del. Code Ann. tit. 8, § 114(b)(1) (2010).

166. That is, the pre-amendment subsection 225(a) listed the following persons who could bring such an action: "any stockholder or director, or any officer whose title to office is contested, or any member of a corporation without capital stock." Del. Code Ann. tit. 8, § 225(a) (2009). While there was a nonstock equivalent to "stockholder," there was no nonstock equivalent for "director."

167. *See* Del. Code Ann. tit. 8, § 225(a) (2010) (referring to "any . . . director"); *id.* § 114(a)(3) (translating references to "directors" to refer to "members of the governing body").

nonstock corporations, requiring a copy of any application to the Delaware Court of Chancery under Section 226 to be provided to the Attorney General of the State of Delaware.[168] New subsection 226(c) does not require the Attorney General to take any action, but the notice requirement was designed to assist the Attorney General in monitoring and policing such corporations.

8. Subchapter VIII—Amendment of Certificate of Incorporation; Changes in Capital and Capital Stock

The DGCL's procedures for amending a nonstock corporation's certificate of incorporation have long differed from those applicable to stock corporations. After a stock corporation has received payment for its capital stock, any amendment to its certificate of incorporation generally must be approved by its board of directors and then adopted by a majority in voting power of its outstanding capital stock (and, depending on the nature of the amendment, also a majority of the holders of one or more class or classes or series of its stock).[169] By contrast, an amendment to the certificate of incorporation of a nonstock corporation must only be approved by a majority of all members of its governing body.[170] That is, no vote of the members of the nonstock corporation is required to effect any such amendment unless the certificate of incorporation expressly requires such a vote.[171]

The 2010 amendments made an important change to Section 241. Pre-amendment, Section 241 addressed a stock corporation's ability to amend its certificate before it received payment for its stock.[172] The 2010 amendments expanded the scope of Section 241 to apply to a nonstock corporation before it has members.[173]

168. *Id.* § 226(c). Similar changes were made to Section 273. *See* text accompanying *infra* note 201.

169. Del. Code Ann. tit. 8, § 242(b) (2010).

170. *Id.* § 242(b)(3).

171. *Id.* This fundamental difference in the approach to the different types of corporations is likely a recognition of the basic difference in the nature of the constituency to which each ultimately answers. Stock corporations, of course, are organized for the benefit of their stockholders, who hold property (stock) representing undivided interests in the assets of the corporation and whose rights, powers, and preferences arising from that property are defined by the certificate of incorporation. Not surprisingly, changes to the instrument defining the terms of that property must be authorized by its owners. Although nonstock corporations may be organized such that their members hold membership interests representing undivided interests in the corporation's assets, they need not be—and in many cases are not. A charitable nonstock corporation, for example, may have thousands of members, not one of whom would be entitled to any distribution upon a merger or dissolution. Moreover, while a stock corporation must receive consideration in exchange for its shares (typically in the form of money paid or services rendered by the stockholder), *id.* § 153, and must maintain a list of its registered stockholders, *id.* § 219, a nonstock corporation may define its membership base through the conditions or criteria of membership, *id.* § 102(a)(4), and need not maintain any specific register of the persons or entities included within its membership ranks, *id.* § 114(b)(2) (providing that Section 219 does not apply to nonstock corporations). This flexibility in the nonstock structure allows for membership bases to be composed of broad and fluid groups, such as "all persons having an interest in the beautification of the public parks of the City of Wilmington." A quorum of that particular membership base, let alone the vote of a majority of those members, would likely be unascertainable.

172. Del. Code Ann. tit. 8, § 241 (2009).

173. *See* Del. Code Ann. tit. 8, 241(c) (2010).

Accordingly, new subsection 241(c) was added to ensure that the procedures in Section 241 would apply (by some translation) to nonstock corporations before such corporations have members.[174] This change ensures that any nonstock corporation whose certificate of incorporation requires a vote of its members for amendments will not be paralyzed if it must make an amendment before its members have been identified.[175]

The 2010 amendments made two changes to Section 242: first, a technical amendment to subsection 242(b)(3)—which sets forth the procedures for amending the certificate of incorporation of a nonstock corporation—to make the terms used therein consistent with the terms used in the Section 114 translator provision; and, second, a substantive change clarifying that subsection 242(b)(4) applies to nonstock corporations.[176] Subsection 242(b)(4) is the DGCL's "anti-sandbagging" provision for amendments to the certificate of incorporation. Before the 2010 amendments, it provided:

> Whenever the certificate of incorporation shall require for action by the board of directors, by the holders of any class or series of shares, or by the holders of any other securities having voting power the vote of a greater number or proportion than is required by any section of this title, the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended or repealed except by such greater vote.[177]

Thus, if the certificate of incorporation contained a provision requiring, for example, that any merger be approved by the vote of two-thirds of the outstanding shares of the corporation's capital stock, any amendment or repeal of that provision would likewise require a two-thirds vote of the outstanding shares. The 2010 amendments added language clarifying that the provision also applies to nonstock corporations.[178]

Sections 243 and 244 are both inapplicable to nonstock corporations[179]—Section 243 because it refers to the retirement of stock, and Section 244 because Section 154 now provides that the capital of nonstock corporations is deemed to be zero.

Finally, the 2010 amendments made technical changes[180] to Section 245 to clarify—with no intent to change the meaning or application of that section—that nonstock corporations may restate their certificates of incorporation.

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174. Section 241 is thus accordingly carved out of Section 114's more elaborate translator provision. *See id.* § 114(b)(1).

175. This situation could exist under the post-amendment DGCL, since now conditions or criteria of membership may be put in the bylaws (and even could have existed pre-amendment, since the conditions or criteria could have relied on facts ascertainable outside the certificate). *See id.* § 102(b)(4), (d).

176. *Id.* § 242(b)(3)–(4).

177. Del. Code Ann. tit. 8, § 242(b)(4) (2009), *amended by* 77 Del. Laws ch. 253, § 35 (2010).

178. 77 Del. Laws ch. 253, § 35 (2010).

179. Del. Code Ann. tit. 8, § 114(b)(2) (2010).

180. Those changes included language regarding subsection 242(b)(3), since nonstock corporations do not require (unless so provided in the certificate of incorporation) a member vote to amend their certificates of incorporation. *See* 77 Del. Laws ch. 253, § 37.

9. Subchapter IX—Merger, Consolidation, or Conversion

Before the 2010 amendments, the DGCL contained provisions applicable to mergers and consolidations involving nonstock corporations. The 2010 amendments largely preserved this structure, making many technical and conforming amendments, some procedural improvements, and one empowering change. Many of the provisions in Subchapter IX are carved out of Section 114's translator provision: Sections 251 and 252 because they do not apply to nonstock corporations,[181] and Sections 253 through 258 because they apply to nonstock corporations by their own terms.

Most notable of the amendments to Subchapter IX is new subsection 253(f), which allows nonstock corporations to take advantage of Delaware's "short-form" merger procedure. Before the 2010 amendments, the DGCL allowed a stock corporation to merge with or into a subsidiary corporation (or corporations) of which it owned 90 percent of each class of stock otherwise entitled to vote on a merger, merely by board resolution and by filing a certificate of ownership and merger.[182] The 2010 amendments extended this procedure to nonstock corporations, subject to three key conditions: First, the nonstock corporation must be the parent corporation.[183] Second, the nonstock corporation must be the surviving corporation in the merger.[184] Third, consistent with the DGCL's other provisions governing mergers, no charitable nonstock corporation may effect a short-form merger if its charitable status would thereby be lost or impaired by virtue of the merger.[185] Given the limitations imposed on short-form mergers involving nonstock corporations, new Section 267, which was also added to the DGCL in 2010 to authorize parent non-corporate entities to effect short-form mergers with one or more subsidiary corporations, was made inapplicable to nonstock corporations.[186]

Section 255 underwent several technical changes designed to ensure consistency with the terms used in Section 114[187] as well as amendments designed to clarify procedures regarding the execution, acknowledgment, adoption, and certification of the merger agreement.[188] Subsection 255(c) was amended to clarify that members may vote on a merger if, under the corporation's certificate of incorporation or bylaws, they are entitled to vote on the merger or for the election of the members of the governing body. Previously, members had only been entitled to vote on a merger if they had been entitled to vote for the election of members of

181. It should be noted, however, that certain provisions of Section 251 are made applicable to nonstock corporations through other provisions in Subchapter IX. *See, e.g.*, Del. Code Ann. tit. 8, § 255(e)–(f) (2010).

182. Del. Code Ann. tit. 8, § 253(a) (2009).

183. Del. Code Ann. tit. 8, § 253(f) (2010).

184. *Id.*

185. *Id.* § 253(g).

186. *Id.* § 114(b)(2).

187. For example, the phrases "memberships" and "membership interest" were added throughout as necessary to ensure that for-profit and nonprofit nonstock corporations were both able to use the merger provisions properly. *See id.* § 255.

188. For example, Section 255 now contains this sentence: "The agreement so adopted shall be executed and acknowledged in accordance with § 103 of this title." *Id.* § 255(b).

the governing body.[189] The amendment to subsection 255(c) further clarifies that the decision to include either a copy or a summary of an agreement of merger or consolidation in a notice of a meeting of the members of a constituent nonstock corporation need not be approved by a specific act of the governing body of the nonstock corporation.[190] New subsection 255(e) was also added, to provide that subsection 251(d) (as translated for application to nonstock corporations) applies to mergers under Section 255.

The most notable change to Section 255 involved circumstances in which no members of the corporation are entitled to vote on the merger other than those who are members of the governing body.[191] Before the 2010 amendments, such mergers first had to be authorized by a majority of a quorum of the governing body and then re-approved by two-thirds of the total number of members of the governing body at a second meeting.[192] After the 2010 amendments, the approval of any such merger may be obtained at a single meeting, by the vote of a majority of the total number of members of the governing body.[193]

Technical and conforming amendments were made to Sections 256, 257, 258, 260, 263, and 264. Amendments were made to Sections 256, 257, and 258 to make subsection 251(d) applicable to nonstock corporations—thereby allowing members of the governing bodies of such corporations to make certain amendments to agreements of merger or consolidation after the approval of those agreements by the members.[194] Finally, the prohibition on certain mergers involving charitable nonstock corporations (based on the provision in subsection 258(d)) was added to Sections 256, 263, 264, and 266. This prohibition ensures that no merger is authorized under the DGCL if that merger would cause the charitable status of the charitable nonstock corporation to be lost or impaired.[195]

Section 262 was amended in several technical ways to ensure that Section 114's translator provision would apply properly and to clarify that appraisal is available for nonstock corporation mergers under Sections 255 and 256.[196] Subsection 262(d) was also amended to provide for notice appropriate to nonstock

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189. Del. Code Ann. tit. 8, § 255 (2009). Similar changes were made elsewhere, including in Sections 271 and 390.

190. 77 Del. Laws ch. 253, § 41 (2010). That amendment, which was also made to comparable provisions involving stock corporations, was not intended to define or limit any duty of members of the governing body relating to disclosure to members in connection with the transaction.

191. *See* Del. Code Ann. tit. 8, § 255(d) (2010).

192. Del. Code Ann. tit. 8, § 255(d) (2009).

193. Del. Code Ann. tit. 8, § 255(d) (2010). This procedure is now akin to that used in amending the certificate of incorporation of a nonstock corporation in which the certificate of incorporation does not require a member vote on amendments. *See id.* § 242(b)(3).

194. *Cf. id.* § 251(d).

195. *See supra* note 35.

196. These amendments were effective only with respect to "transactions consummated pursuant to agreements entered into after August 1, 2010 (or, in the case of mergers pursuant to Section 253, resolutions of the board of directors adopted after August 1, 2010), and appraisal proceedings arising out of such transactions." 77 Del. Laws ch. 253, § 71 (2010).

corporations.[197] It should be noted, however, that Section 262 does not apply to nonprofit nonstock corporations.[198]

10. Subchapter X—Sale of Assets, Dissolution, and Winding Up

Several changes were made to the provisions in Subchapter X of the DGCL, but many of those changes were conforming changes designed to ensure that the translator provision in Section 114 applies correctly.

One change was made to Section 271 to clarify that members of a nonstock corporation may vote on a sale, lease, or exchange of all or substantially all of the corporation's property and assets if, under the corporation's certificate of incorporation or bylaws, the members are entitled to vote on such a transaction or for the election of the members of the governing body.[199] Section 271 was also carved out of Section 114's translator provision[200] because it expressly applies to nonstock corporations already.

Section 273 was amended (along the lines of the changes made to Section 226[201]) to provide that, when a petition for dissolution of a two-member charitable nonstock corporation is filed, the petitioner must provide a copy of the petition to the Attorney General of the State of Delaware within a week of its filing.[202] This amendment does not require the Attorney General to take any action; the notice requirement was merely intended to assist the Attorney General in monitoring and policing charitable nonstock corporations.

Section 276 provides a procedure for dissolving nonstock corporations, adopting in large part the procedures set forth in Section 275. Section 276 received technical amendments in conformance with Section 114 and the other 2010 amendments, but it is not translated by Section 114 because it applies to nonstock corporations by its own terms.[203] It was amended in a few substantive ways as well. First, Section 276 was amended to clarify that members may vote for dissolution if, under the corporation's certificate of incorporation or bylaws, they are entitled to vote on a dissolution.[204] Members entitled to vote for the election of the members of the governing body were already entitled to—and are still entitled to—vote on a dissolution.[205] Second, Section 276 was amended to clarify that a corporation's members may authorize dissolution, without action being taken by

197. That is, along with the copy of Section 262 that must be sent to the members, a copy of Section 114 must also be sent. DEL. CODE ANN. tit. 8, § 262(d)(1)–(2) (2010).
198. *Id.* § 114(c)(2).
199. *Id.* § 271(a). A similar change was also made in Section 255. *See* text accompanying *supra* note 189.
200. DEL. CODE ANN. tit. 8, § 114(b)(1) (2010).
201. *See* text accompanying *supra* note 168.
202. DEL. CODE ANN. tit. 8, § 273(c) (2010).
203. *Id.* § 114(b)(1).
204. Similar changes were made to Sections 255, 271, 312, and 390. *See, e.g.*, *supra* notes 189 and 199.
205. DEL. CODE ANN. tit. 8, § 276 (2010); DEL. CODE ANN. tit. 8, § 276 (2009).

the members of the governing body, if all the corporation's members entitled to vote consent in writing and if a certificate of dissolution is properly filed with the Secretary of State of the State of Delaware.[206]

Pursuant to the 2010 amendments, Sections 280, 281, and 282 apply to nonstock corporations.[207] Nonstock corporations therefore now may take full advantage of the DGCL's provisions regarding notice and distribution to claimants upon dissolution, as well as the accompanying protections[208] for members and members of the governing body. Sections 280 and 281 were amended to provide that, for nonprofit nonstock corporations, the provisions regarding distributions to members will not apply to the extent that those provisions conflict with any other applicable law or with the corporations' certificate of incorporation or bylaws.[209] Many nonprofit or charitable nonstock corporations contain express provisions in their certificates of incorporation requiring them (or they are required by federal law) upon dissolution to distribute their assets to other entities exempted from federal income tax under I.R.C. § 501(c)(3) or to a state or local government. Therefore, Sections 280 and 281 will apply to these corporations, except to the extent that distributions to members are prohibited by any applicable law or by the corporation's certificate of incorporation or bylaws. Section 280 was also amended to provide that notice given by a nonstock corporation under subsection 280(a)(3) must include a copy of Section 114.[210]

11. Subchapter XI—Insolvency; Receivers and Trustees

No changes were made to the provisions in Subchapter XI of the DCGL, and such provisions apply to nonstock corporations pursuant to the translator provision in Section 114.[211]

12. Subchapter XII—Renewal, Revival, Extension, and Restoration of Certificate of Incorporation or Charter

A handful of important changes were made to the provisions of Subchapter XII of the DGCL.

First, new subsection 311(f) was added, to provide that a nonstock corporation can revoke its dissolution.[212] This revocation procedure (which is similar to that of a stock corporation) is expressly analogous to the procedure employed to

206. Del. Code Ann. tit. 8, § 276(a) (2010).

207. *See id.* § 114(b) (not excepting these sections from Section 114's translator provision). The amendments to these sections are "effective only with respect to dissolutions made effective after August 1, 2010, and the filing of claims arising out of such dissolutions." 77 Del. Laws ch. 253, § 71 (2010).

208. *See* Del. Code Ann. tit. 8, §§ 281(c), 282 (2010).

209. *Id.* §§ 280(g), 281(f).

210. *Id.* § 280(g).

211. *See id.* § 114(b) (not excepting these sections from Section 114's translator provision).

212. *Id.* § 311(f).

authorize the corporation's dissolution. That is, the members entitled to vote on dissolution[213] may vote to revoke that dissolution. The nonstock corporation must file a certificate of revocation of dissolution containing information comparable to that described in subsection 311(a)(4) for a stock corporation.[214] Subsection 311(f) also ensures that the provision in Section 311 regarding annual meetings (subsection 311(c)) does not apply to nonstock corporations.[215]

Section 312, governing the renewal and revival of certificates of incorporation, was amended in conformance with the terms used in Section 114. It was also amended to clarify that members may vote for renewal or revival if, under the corporation's certificate of incorporation or bylaws, they are entitled to vote for dissolution or for the election of the members of the governing body.[216] Other changes to Section 312 clarified that subsection 312(j) is subject to the provisions of Section 313 (governing the renewal of certificates of incorporation of certain religious, charitable, or educational corporations) and that subsection 312(i) does not apply to nonstock corporations.[217]

Finally, subsection 313(a) was amended slightly to provide that Section 313 applies to all "exempt corporations" as defined by subsection 501(b).[218]

13. Subchapter XIII—Suits Against Corporations, Directors, Officers, or Stockholders

No changes were made to the provisions in Subchapter XIII of the DGCL, but two notes are in order. First, Section 324 (governing attachment of shares of stock) was made inapplicable to nonstock corporations.[219] Second, although Section 327 applies to all nonstock corporations, the 2010 amendments did not include an affirmative grant to members of nonprofit or charitable nonstock corporations of any right to sue derivatively.[220]

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213. This is as determined by Section 276. *Id.*

214. *Id.*

215. Similarly, subsection 211(c) is expressly inapplicable to nonstock corporations. *Id.* § 215(a).

216. *Id.* § 312(j). Similar changes were made to other sections of the DGCL. *See supra* note 204.

217. Del. Code Ann. tit. 8, § 312(j) (2010). Subsection 311(f) contains a similar provision. *See* text accompanying *supra* note 215.

218. Exempt corporations are defined as any corporation organized under the DGCL (including stock corporations and nonstock corporations) that:

> (1) Is exempt from taxation under § 501(c) of the United States Internal Revenue Code (26 U.S.C. § 501(c)) or any similar provisions of the Internal Revenue Code, or any successor provisions;
> (2) Qualifies as a civic organization under § 8110(a)(1) of Title 9 or § 6840(4) of Title 16;
> (3) Qualifies as a charitable/fraternal organization under § 2593(1) of Title 6;
> (4) Is listed in § 8106(a) of Title 9;
> (5) Is organized primarily or exclusively for religious or charitable purposes; or
> (6) a. Is organized not for profit; and b. No part of its net earnings inures to the benefit of any member or individual.

Del. Code Ann. tit. 8, § 501(b) (2010).

219. *Id.* § 114(b)(2).

220. *See supra* text accompanying notes 106–07.

14. Subchapter XIV—Close Corporations; Special Provisions

Given the flexiblity granted to nonstock corporations in organizing their management and internal affairs, the 2010 amendments clarified that Subchapter XIV is inapplicable to nonstock corporations.[221]

15. Subchapter XV—Foreign Corporations

Since Subchapter XV governs foreign corporations, and not corporations organized under Delaware law, the 2010 amendments clarified that Subchapter XV does not apply to nonstock corporations.[222]

16. Subchapter XVI—Domestication and Transfer

Using the mechanism set forth in Section 276 as a model, new subsection 390(i) was added to Section 390 to provide that nonstock corporations may transfer to or domesticate or continue in any foreign jurisdiction in a manner analogous to that applicable to a stock corporation.[223] The acts taken by members to authorize a transfer, domestication, or continuance are to be taken by (1) any member entitled to vote thereon pursuant to the corporation's certificate of incorporation or bylaws, as well as (2) any member entitled to vote on "a merger, consolidation, or dissolution of the corporation," and (3) "any other holder of any membership interest in the corporation."[224] This provision was intended to parallel subsection 390(b)'s requirement that "all outstanding shares of stock of [a stock] corporation, whether voting or nonvoting," vote to adopt a resolution for transfer, domestication, or continuance.[225] As with subsection 390(b), the requirement that all "holder[s] of any membership interest" vote in favor of a resolution for transfer, domestication, or continuance of a nonstock corporation was designed to moot the issue of appraisal rights upon transfer or domestication.[226] Finally, in the case of a charitable nonstock corporation, the new subsection requires that the Attorney General of the State of Delaware must be provided with notice of the corporation's intent to effect a transfer, domestication, or continuance ten days before the date of the proposed transfer, domestication, or continuance.[227] The new subsection does not, however, require that any action be taken by the Attorney General.[228]

221. Del. Code Ann. tit. 8, § 114(b)(3) (2010).
222. *Id.*
223. *Id.* § 390(i).
224. *Id.*
225. *See id.* § 390(b).
226. *See id.* § 262(a) (allowing appraisal only for members who do not vote in favor of, or consent to in writing, a merger or consolidation).
227. *Id.* § 390(i).
228. *See id.*

17. Subchapter XVII—Miscellaneous Provisions

One minor change was made to Section 391. The definition of "exempt corporation" that used to appear in subsection 391(j) was moved to subsection 501(b), so subsection 391(j) merely refers to that definition in its new location.

18. Chapter 5—Corporation Franchise Tax

A few changes were made to Chapter 5. First, the definition of "exempt corporation" was moved from subsection 391(j) to subsection 501(b) and expanded to include stock corporations.[229] Then, subsection 501(a) was amended to clarify that all exempt corporations are exempt from the corporate franchise tax. Finally, subsection 503(a)(1) was amended to provide that the franchise tax applicable to nonstock corporations (except exempt corporations, which are exempt from the franchise tax) is $75. Since Section 503 calculates franchise tax based on either (a) the number of shares authorized or (b) the "assumed no-par capital" of the corporation,[230] for-profit nonstock corporations had for years been the beneficiaries of a franchise-tax loophole. The 2010 amendments closed that loophole and ensured that for-profit nonstock corporations (but not nonprofit nonstock corporations, which are exempt under Section 501) pay a corporate franchise tax, albeit at the lowest rate.

III. Implications of the Nonstock Amendments for Practitioners

Following the 2010 amendments, Delaware's nonstock corporation law is stronger and more flexible than it ever has been. Nonstock corporations and their advisors now can be more certain of their actions and can take advantage of the express statutory guidance in the DGCL. The 2010 amendments also provided practitioners with additional reasons to consider forming Delaware nonstock corporations.

For-profit nonstock corporations should be poised to take full advantage of the 2010 amendments. The flexibility and ease of use of the revised DGCL redounds particularly to the benefit of for-profit nonstock corporations. For example, such corporations can easily define their own desired ownership and governance structures with express statutory flexibility under subsections 102(a)(4) and 141(j). At the same time, such corporations are not required to follow all stock-corporation formalities, like holding annual stockholder meetings and maintaining stocklists. In particular, small businesses should be perfect candidates for Delaware nonstock corporations—they obtain the benefits of Delaware's excellent court system and developed corporate caselaw, the structural and operating flexibility of a limited liability company (albeit without the statutory freedom to modify fiduciary

229. *See id.* § 501(b). A corresponding change to subsection 505(c) was made to account for the restructuring of Section 501.

230. *See id.* § 503(a)(1)–(2).

duties), the solid foundation of a Delaware corporation, and the freedom from many of the formalities of Delaware stock corporations. Finally, the annual franchise tax for for-profit nonstock corporations is as low as the lowest possible tax rate for stock corporations and is lower than the annual fee for Delaware's limited liability companies.[231]

Nonprofit nonstock corporations and charitable nonstock corporations can also take advantage of the revised DGCL. In effect, the 2010 amendments have created a specific corporation law for nonprofit nonstock corporations. That enhanced statutory guidance, along with the flexibility built into the DGCL, provides certainty and clarity for these nonprofits and their advisors. Delaware's caselaw provides the members of the governing bodies of nonprofit nonstock corporations with the same protection provided to directors of stock corporations,[232] and the post-amendment DGCL contains several safe harbors to protect such corporations from the consequences of "foot-fault" violations of certain statutory requirements.[233] Further, the revised law provides nonprofit corporations with significant flexibility in designing optimal governance structures and in setting forth types and qualifications of members (and allowing members to be the members of the governing body). Finally, all nonprofit nonstock corporations are exempt from Delaware's annual franchise tax.[234]

IV. Conclusion

In all, the 2010 amendments resulted in many changes to the DCGL, but most of those changes were merely confirmatory of Delaware law as most practitioners conceived of it before the amendments. Delaware's nonstock corporations, and particularly its nonprofit and charitable nonstock corporations, now have a solid statutory foundation and clear governing law. It was the intention of the 2010 amendments that such corporations face few (or no) new requirements or obligations but instead reap the benefits of the new clarity, the multiple safe harbors, and the added flexibility in the DGCL. Furthermore, the flexibility of the nonstock-corporation form (in particular, the leeway granted by subsection 141(j), the lack of requirements for annual meetings and various other formalities required for stock corporations, and the ease of conversion to a stock corporation[235]), coupled with the strength and stability of Delaware corporate law, should allow many entrepreneurs and small-business owners to take advantage of nonstock corporations when choosing a corporate form.

231. *See* Del. Code Ann. tit. 6, § 18-1107 (2010). It should be noted, however, that a substantial increase in the adoption of for-profit nonstock corporations might lead to an increase in the annual franchise tax for such corporations.

232. *See* text accompanying *supra* note 108.

233. *See* text accompanying *supra* notes 77–84.

234. Del. Code Ann. tit. 8, § 501 (2010). Such corporations still, however, must pay a reporting fee, but that reporting fee is discounted by half. *Id.* § 391(a)(18).

235. *See, e.g.*, Farahpour v. DCX, Inc., 635 A.2d 894, 899–900 (Del. 1994).

A Realistic Approach to Officer Liability

*By Paul Graf**

Discussion of officer liability has remained largely dormant since the dueling commentaries of Lyman Johnson, and Lawrence Hamermesh and A. Gilchrist Sparks III, five years ago. Recently, in Gantler v. Stephens, *the Delaware Supreme Court held that officers owe the same fiduciary duty of care as do directors, but it did not resolve whether officer liability for breach of the duty of care is based on the gross negligence standard applicable to directors, or the more stringent standard of simple negligence. This article uses a practical and realistic approach to officer liability that counterbalances the theoretical arguments of Lyman Johnson, and suggests alternatives that will preserve sound corporate governance and shareholder value.*

I. Introduction

Treatises, casebooks, institutes, and seminars too numerous to mention have addressed the fiduciary duties of corporate directors. The fiduciary duties of officers, by contrast, have remained under the legal radar. It is simply a matter of time before the Delaware courts venture into the uncharted waters of officer liability. Before the judiciary weighs in, it is important to consider the practical and legal issues that will steer the courts. This article continues the work of officer-liability commentators by offering a different, and perhaps more realistic, perspective.

In 2005, Professor Lyman Johnson stated gravely that "[c]orporate officers stand at the very center of recent business scandals," and observed that state corporate law has been "strangely silent" on officer liability issues.[1] Lawrence Hamermesh and A. Gilchrist Sparks III likewise found the lack of "'attention from courts and commentators' . . . [to be] surpris[ing] . . . 'given the large

* Paul Graf is an Assistant Professor at San Diego State University and Deputy Director of the Corporate Governance Institute. Prior to teaching, he was Senior Vice President and General Counsel of GE Capital Business Asset Funding Corporation. He is a graduate of the Northwestern University School of Law.

1. Lyman P. Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 439 (2005). Johnson and Dennis Garvis have also referred to the lack of attention to corporate officers as follows: "Corporate law's treatment of officers is like the weather: everybody talks about it but nobody does anything about it." Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 Bus. Law. 1105, 1105 (2009). They also stated:

size of many businesses and the concomitant necessity of delegating managerial responsibilities.' "[2]

Around the same time, the former Chief Justice of the Delaware Supreme Court, Norman Veasey, predicted a new focus on litigation against officers in response to the high-profile corporate wrongdoing at companies like Enron and WorldCom.[3] In anticipation of the officer-focused litigation, the Delaware legislature gave the Delaware Court of Chancery personal jurisdiction over officers of Delaware corporations.[4]

However, more than five years later, issues of officer liability remain unresolved. What accounts for this continued "puzzling void" in corporate law?[5] Professors Johnson and David Millon would fill the void with greater officer accountability. They contend that officers should be differentiated from directors for purposes

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> Besides being neglected by legislators and judges, other influential actors also pay little heed to corporate officers. In law schools, the key training ground for lawyers, most casebooks accord only cursory attention to the fiduciary duties of executives, often lumping them with the more extensively covered duties of directors, if they are treated at all. The same is true of corporate law treatises, along with the many institutes, conferences, and professional meetings designed for the practicing lawyer. Corporate law scholarship also has largely neglected the role of officers in corporate governance—preferring to focus on directors and shareholders—with the result that the position of officers in corporate affairs remains under-theorized.

Id. at 1108; *see also* Lyman P. Q. Johnson & Robert V. Ricca, *(Not) Advising Corporate Officers About Fiduciary Duties*, 42 Wake Forest L. Rev. 663, 666 (2007) ("Delaware law contains abundant dicta on, but has never squarely addressed, the issue of whether officers are subject to the same fiduciary duties as directors." (footnote omitted)).

2. Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 865, 867 n.13 (2005) (quoting A. Gilchrist Sparks III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 Bus. Law. 215, 215 (1992)).

3. E. Norman Veasey, *Corporate Governance and Ethics in the Post-Enron WorldCom Environment*, 38 Wake Forest L. Rev. 839, 851 (2003) ("The second likely development is going to be a new focus on litigation going after officers as actors in fraud cases, as distinct from or in addition to more litigation against directors for inadequate oversight.").

4. Del. Code Ann. tit. 10, § 3114(b) (1999 & Supp. 2008) ("Every non-resident of this State who . . . accepts election or appointment as an officer of a corporation organized under the laws of this State . . . shall, by such acceptance . . . , be deemed thereby to have consented to . . . proceedings brought in this State.").

5. Lyman P. Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 Wm. & Mary L. Rev. 1597, 1601 (2005) ("Hardly a week goes by without yet another Delaware decision addressing the subject of director duties. Yet, surprisingly, no Delaware decision has ever clearly articulated the subject of officer duties and judicial standards for reviewing their discharge. For persons occupying such central places of power in corporations, senior officers have largely succeeded in eluding the distinctive attention of state corporation law. This is a puzzling void."). ***But see*** Hampshire Grp., Ltd. v. Kuttner, No. 3607-VCS, 2010 WL 2739995 (Del. Ch. July 20, 2010). In *Hampshire Group*, Vice Chancellor Strine appeared willing to consider arguments regarding the appropriate standard to apply in an action against an officer for the breach of the duty of care, but since the parties in the lawsuit agreed that the gross negligence standard applicable to directors should also apply to officers, he elected not to pursue the matter on his own initiative. It appears, however, that Strine may well have imposed a higher standard on officers: "Generally, like directors, Clayton and Clark were expected to pursue the best interests of the company in good faith (*i.e.*, to fulfill their duty of loyalty) and to use the amount of care that a reasonably prudent person would use in similar circumstances (*i.e.*, to fulfill their duty of care)." *Id*. at *11 (footnote omitted).

of liability because an officer's proximity to the action justifies imposing a higher standard of care on officers in corporate decision making.[6]

This article argues that it is precisely those differences that account for the hesitancy of the courts to address issues of officer liability in the context of the duty of care. Furthermore, this article suggests that any effort to impose liability on officers for breaching their duty of care needs to be examined from a practical as well as a theoretical standpoint. This article will focus on Professor Johnson's theoretical approach to officer liability and test it with practical applications. Only a balanced review of all factors, both legal and non-legal, will prevent an overreaction to isolated corporate malfeasance. The purpose of this article is to persuade the reader that for liability purposes there is no compelling reason to hold officers to a higher standard than corporate directors. Accordingly, therefore, officers should be entitled to the same statutory protections and favorable legal presumptions as are available to corporate directors.

Part II examines distinctions between officers and directors to determine if their differing roles in corporate governance justify the creation of a liability dichotomy. Part III examines the same issues from the standpoint of agency law; namely, does a corporate officer's status as an agent of the corporation validate a more stringent standard of care, or is agency an unpersuasive technicality? Part IV evaluates the appropriateness of excluding officers from the protective presumptions of the business judgment rule. This analysis also considers the desirability of the judicial second-guessing of an officer's decision-making process. Part V considers the definition of "officer" in the context of officer liability. Part VI predicts the possible effects that creating officer liability for breaches of the duty of care would have on corporate governance. Finally, Part VII advances alternative courses of action for addressing officer shortcomings with respect to the duty of care.

II. Distinctions Without Differences

In *Gantler v. Stephens*, the Delaware Supreme Court held that "corporate officers owe fiduciary duties that are identical to those owed by corporate directors."[7] Furthermore, officers and directors both owe such fiduciary duties to the corporation and its shareholders.[8] Since officers and directors owe the same fiduciary

6. Johnson & Millon, *supra* note 5, at 1603 ("Recalling the agency law status of corporate officers, however, does more than preserve state law as the cornerstone of governance relationships in our federal system. At a practical level, and this is the second benefit of our thesis, it clarifies immensely why courts can and should scrutinize officer conduct more closely than they now review director performance—i.e., the fiduciary duties of agents are more demanding than those of directors, and officers rightly face a greater risk of personal liability for misconduct.").

7. 965 A.2d 695, 708–09 (Del. 2009) ("That issue—whether or not officers owe fiduciary duties identical to those of directors—has been characterized as a matter of first impression for this Court. . . . We now explicitly so hold." (footnotes omitted)).

8. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("A public policy . . . has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . to protect the interests of the corporation committed to his charge . . . ."); *In re*

duties to the same corporations and shareholders, why do they not have identical liability for a breach of those duties?

Johnson and Millon claim that "courts can and should scrutinize officer conduct more closely than they now review director performance," and that "officers rightly face a greater risk of personal liability for misconduct,"[9] without the protection of the business judgment rule[10] (discussed hereafter in Part IV). Aaron Jones concurs with this assessment, stating that such officer liability would "reinvigorate" theories of officer duties and "breathe some life into the duty of care."[11] In short, these commentators are in general agreement that officers should not only be held accountable for breaches of the fiduciary duty of care but also should, in some circumstances, be held to a standard of ordinary negligence, even though directors have been held to the lesser standard of gross negligence since the 1984 Delaware Supreme Court decision in *Aronson v. Lewis*.[12]

If, as the commentators advocate, officers and directors should be treated differently for liability purposes, then what are the distinguishing characteristics of officers that justify imposing a more demanding standard on them?

A. Delegation and Control Issues

Section 141 of the Delaware General Corporation Law states: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . ."[13] An officer's authority, therefore, must be derived from the board through the delegation of the directors'

Walt Disney Co. Derivative Litig., No. 15452, 2004 WL 2050138, at *3 n.38 (Del. Ch. Sept. 10, 2004) ("[T]he fiduciary relationship that an officer or director owes to the corporation and its shareholders has long been recognized in Delaware jurisprudence."); *see also* Lisa L. Casey, *Twenty-Eight Words: Enforcing Corporate Fiduciary Duties Through Criminal Prosecution of Honest Services Fraud*, 35 Del. J. Corp. L. 1, 12 (2010) ("Universally, as in Delaware, directors and officers owe fiduciary duties to their firms in order to discipline managers' self-interested conduct." (footnote omitted)).

9. Johnson & Millon, *supra* note 5, at 1603.

10. Stephen Radin defines the rule as follows: "The business judgment rule is a standard of judicial review of director conduct, not a standard of conduct. The rule is 'a presumption that [directors] were faithful to their fiduciary duties' and 'presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.'" 1 Stephen A. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors 11 & n.10 (6th ed. 2009) (quoting Beam v. Stewart, 845 A.2d 1040, 1048 (Del. 2004); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (footnotes omitted) (internal citation omitted)).

11. Aaron D. Jones, *Corporate Officer Wrongdoing and the Fiduciary Duties of Corporate Officers Under Delaware Law*, 44 am. Bus. L.J. 475, 478 (2007).

12. 473 A.2d 805, 812 (Del. 1984) ("While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence."); *see also In re* Citigroup S'holder Derivative Litig., 964 A.2d 106, 122 (Del. Ch. 2009) ("[D]irector action is analyzed under the business judgment rule, which prevents judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available—a standard measured by concepts of gross negligence.").

13. Del. Code Ann. tit. 8, § 141(a) (2001).

statutory authority.[14] Obviously, the board controls the level of specificity of each delegation. Vague or implied delegations give officers more discretion to decide how to satisfy board directions. The more discretion allowed an officer, the greater the opportunities for the officer's conduct to be challenged as a breach of the duty of care. If decision making is delegated to officers, then, according to Johnson, they should be personally liable for failing to use ordinary care in making decisions. Hamermesh and Sparks refer to this as "discretionary delegated authority."[15]

However, Z. Jill Barclift correctly notes that "ultimate risk taking decisions rest with the board and not senior officers,"[16] but that "[r]isk taking is exactly what the board wants senior officers to do—to increase firm value."[17] Also, she adds that "boards have a great deal of discretion to decide what matters senior officers must submit to the board for review or approval."[18] Since boards control the discretionary issues delegated to officers, it is unfair for directors to hide behind insulation from liability under a lesser standard. There is something unsettling about directors being held to a standard of gross negligence if they retain discretionary authority, but officers being held to ordinary negligence if that discretion is assigned to them. Also, as Hamermesh and Sparks suggest, placing officers at greater risk for care-based liability would frustrate governance practices, since officers would "place more decisions in the hands of the board, and . . . take fewer, and less risky, initiatives on their own, so as to avoid liability."[19]

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14. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 762 n.490 (Del. Ch. 2005) ("Section 141(a) of DGCL expressly permits a board of directors to delegate managerial duties to officers of the corporation, except to the extent that the corporation's certificate of incorporation or bylaws may limit or prohibit such a delegation." (quoting Chapin v. Benwood Found., Inc., 402 A.2d 1205, 1211 (Del. Ch. 1979) (quoting Ambercrombie v. Davies, 123 A.2d 893, 899 (Del. Ch. 1956)), *aff'd sub nom*. Harrison v. Chapin, 415 A.2d 1068 (Del. 1980))); *see also In re* Nymex S'holder Litig., Nos. 3621-VCN, 3835-VCN, 2009 WL 3206051, at *7 (Del. Ch. Sept. 30, 2009) ("It is well within the business judgment of the Board to determine how merger negotiations will be conducted, and to delegate the task of negotiating to the Chairman and the Chief Executive Officer."); Michelle M. Harner, *Corporate Control and the Need for Meaningful Board Accountability*, 94 Minn. L. Rev. 541, 551 (2010) ("The board of directors routinely delegates the day-to-day operations of the corporation to senior management. As a result, the board and senior management typically direct the business affairs of the corporation. Shareholders and other corporate stakeholders have little day-to-day input." (footnotes omitted)).

15. Hamermesh & Sparks, *supra* note 2, at 865. Hamermesh and Sparks state that officers should not be shielded by the business judgment rule for conduct "outside the scope of their delegated authority." *Id.* at 866. This analysis begs the question, when does a board delegate authority? Does the delegation need to be directed to a particular officer? Must the delegation be express—for example in the minutes—or can it be implied? If the officer's job description includes responsibility for the conduct in question, is this sufficient to constitute a "delegation"?

Hamermesh and Sparks focus attention on the delegation processes. In practice, boards do not often do the kinds of formal delegation that the commentators suggest. If delegation is a key component of the officer liability analysis, boards would be well-advised to reconsider their delegation practices.

16. Z. Jill Barclift, *Fuzzy Logic and Corporate Governance Theories*, 6 Pierce L. Rev. 177, 203 (2007).

17. *Id.* at 202.

18. *Id.* at 203.

19. Hamermesh & Sparks, *supra* note 2, at 875.

In this regard, it is important to note that a delegation by the board to corporate officers is a transfer of discretionary authority for which the board retains responsibility. According to Robert Monks and Nell Minow, the primary responsibility of the board of directors is to monitor management on behalf of shareholders.[20] Specifically, Monks and Minow state: "The single major challenge addressed by corporate governance is how to grant managers enormous discretionary power over the conduct of business while holding them accountable for the use of that power."[21] If directors have the power to delegate managerial power to officers coupled with the right to determine how much discretion to grant those officers, and directors bear the related obligation to monitor the officers' exercise of that discretion, does it make sense to hold officers to a higher standard of care? If directors divest themselves of responsibility by delegating substantial discretion to officers without meaningful guidance, and then neglect to monitor the exercise of that discretion, should directors not be held accountable at least to the same extent as officers? To do otherwise is to grant directors a license to shirk responsibility with impunity.

Paradoxically, directors are frequently referred to as "professionals."[22] If directors are "professional" at managing corporate America, should directors escape liability while the officers under their charge are held to a standard of ordinary negligence? As stated above, the court in *Aronson* held that directors are held to only a standard of gross negligence when discharging their fiduciary duty of care. Apparently reflecting a concern that a gross negligence standard might not sufficiently protect directors in the performance of their duties, Delaware permits corporations to insulate directors from monetary liability for breaching the duty of care.[23] Roberta Romano gave the reasoning for the protective statute as follows:

> This enactment [§ 102(b)(7)] came on the heels of a controversial 1985 Delaware Supreme Court decision, *Smith v. Van Gorkom*, which found directors grossly negligent in accepting a bid for their firm. Critics predicted that the decision would lead

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20. Robert A. G. Monks & Nell Minow, Corporate Governance 193 (3d ed. 2004); *see also In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("But it is important that the board exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."); Paul J. Graf, *Red Flags in the Morning, Directors Take Warning*, Bus. L. Brief, Spring/Summer 2010, at 19, 20 ("Information revealed through the monitoring process should not, therefore, be viewed in isolation. Information is just unusable data if there is no comparison to standards, norms, historical information, strategic plans, and expectations.").

21. Monks & Minow, *supra* note 20, at 196; *see also Caremark*, 698 A.2d at 970.

22. Paul J. Graf, *Should a 'Professional Director' Be Treated as a Professional—Or as a Rara Avis?*, 15 J.L. & Bus. 25, 26 (2008) ("[Ira] Millstein noted that the role of the board is expanding and that this 'expansion is leading to, and ultimately will require, a more professional board; a board with standards to perform, and with a constant dissatisfaction with status-quo thinking.'" (quoting Ira Millstein, *The Professional Board*, 50 Bus. Law. 1427, 1440 (1995))).

23. Del. Code Ann. tit. 8, § 102(b)(7) (2001). Section 102(b)(7) allows companies to adopt a provision in their certificate that eliminates the personal liability of directors for monetary damages for breach of fiduciary duty as a director, except for, among other things, breaches of the duty of loyalty and acts or omissions not in good faith or which involve intentional misconduct.

> talented individuals to resign from boards and blamed the decision for the mushrooming insurance crisis. The decision exemplifies the legal uncertainty that contributed to the insurance crisis . . . .[24]

The rationale for insulating directors is equally as applicable to officers. If officers are confronted by uninsulated exposure to unlimited liability for simple negligence, officers would also ponder whether the rewards of being an officer outweigh the risks of substantial personal liability for failing to act with ordinary care. Or, well-honed self-preservation instincts may cause officers to maneuver and evade so that decisions are not traceable to their office. Such defensive tactics would result in dysfunctional decision-making processes that would compromise managerial effectiveness during a crisis.

Furthermore, a higher standard of care for officers would be theoretically inconsistent with other federal statutes. In securities law, "control persons" are jointly and severally liable for violations of their subordinates if they were in control of the subordinate, unless the "control person" acted in good faith and did not have "knowledge of or reasonable grounds to believe the existence of the facts" upon which liability is predicated.[25] Directors are in control of corporations pursuant to section 141(a).[26] The board controls officers because all power of officers is derived from delegation by the board. Since directors are aware of their delegations and are charged with monitoring the delegated assignments, should directors not be characterized as "control persons"?

A board could defend an action for control person liability by claiming that it lacked direct knowledge of the offending act, but should a board that has its collective head in the sand be absolved from liability while the officer that it controls is left dangling? The duty to monitor is active, not passive.[27] Arguably, a casual, insincere, and negligent monitor enables the offending event because active monitoring would have discovered and prevented or minimized the wrongdoing. In fairness, the enabler should suffer the same fate as the enabled. Or, if the enabler is given a pass, then the enabled should not be saddled with sole responsibility.

Johnson's case for requiring more stringent standards for officers relies on purely theoretical constructs. Sometimes, however, theoretical analysis departs from reality. Therefore, his analysis should be tested both practically and theoretically. Accordingly, using a two-pronged approach, is it fair and justifiable for an

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24. Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 Emory L.J. 1155, 1160 (1990) (footnote omitted).

25. 15 U.S.C. § 77o (2006) ("Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77*l* of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.").

26. *See* Del. Code Ann. tit. 8, § 141(a) (2001).

27. Graf, *supra* note 20, at 21 ("If monitoring to detect red flags is to be purposeful, it must mean more than the board having a collective 'V-8' moment.").

officer to be held to a standard of ordinary negligence in the following hypothetical situations?

1. An officer neglects to solicit from a trusted subordinate input that would have prevented losses to the corporation.
2. An officer could have purchased a major piece of equipment for a cheaper price, but neglected to insist that the purchasing department source the equipment internationally.
3. A new product is a financial flop because the supervising officer was unduly swayed by a marketing presentation when additional research would have revealed flaws in the strategy.
4. A corporation is the victim of fraud by an employee, and the officer who hired the employee neglected to request a criminal background check, choosing instead to rely on the unqualified endorsement by a well-regarded colleague and seemingly valid employment records.

In all of these examples, the decision-making process of the officer was arguably negligent. But all of the examples occur on a regular basis in corporate America. Having worked as general counsel in major corporations for twenty-five years, I can safely say that not once did I consider that my decisions might be perceived as negligent, or expose me to personal liability. Had I been exposed to personal liability for any of my countless daily decisions regarding sophisticated financial transactions or complex litigation, it would have caused decision paralysis. Officers believe the maximum penalty for neglectful conduct in fulfilling job responsibilities is disciplinary action or expulsion, not monetary damages. Subjecting well-intentioned officers to liability for simple negligence is a paradigm shift that should be approached cautiously, and only after taking both the bigger picture and very real practical considerations into account.

B. Access to Information

One reason Johnson argues that officers should be held to a higher standard of care than directors is that officers "have access to considerably more and better information than directors."[28] Likewise, Sparks and Hamermesh point to the fact that the official comment to section 8.42 of the Model Business Corporation Act "suggests that an officer's accessibility to corporate information may subject the officer to a higher standard of scrutiny."[29]

Unfortunately, this theoretical analysis ignores certain realities of corporate America. First, the analysis assumes that officers have unfettered access to information, apparently because of their status as officers. This might be true were it not for the insidious effects of corporate "silos, politics and turf wars."[30] In many

28. Johnson, *supra* note 1, at 460.

29. A. Gilchrist Sparks III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 Bus. Law. 215, 218 (1992) (quoting Model Bus. Corp. Act § 8.42 cmt.).

30. *See generally* Patrick Lencioni, Silos, Politics and Turf Wars: A Leadership Fable About Destroying the Barriers that Turn Colleagues into Competitors (2006); *see also* David Aaker, Spanning Silos: The New CMO Imperative 4–20 (2008).

corporations, information is power, and frequently that power is not surrendered willingly. Johnson appears to suggest that a single keystroke on a computer will magically produce all of the relevant information needed for a rational decision. The process of gathering information is fraught with numerous obstacles; to suggest that assumed access to greater volumes of information should result in greater exposure to liability for the gatherer is unpersuasive.

Edward Rock and Michael Wachter summarize the practical difficulties of determining negligence of officers based on access to information as follows: "[T]he distribution of information is such that third parties [courts] cannot reliably determine whether parties behaved negligently or not."[31] In other words, the contextual aspects of information distribution and use within a corporation make determinations regarding fault exceedingly difficult, especially for a court that lacks insight into the inner workings of corporations.

Another constraint is that officers are frequently under time pressure when processing information. In a perfect world there would be unlimited amounts of time to gather and process information prior to making decisions, but opportunities do not wait for officers to complete the optimal review of information. Research has shown that time pressure adversely affects decision-making processes.[32] Furthermore, digging for information carries a cost. Max Bazerman acknowledges that "[t]here comes a point when the value of the additional information is insufficient to cover the costs of the added search."[33] The bald assertion that officers should face liability for ordinary negligence due to greater access to information ignores the realities and constraints of information gathering in the corporate environment.

Johnson's analysis also skims over the fact that directors are responsible for managing corporate operations. They have the right, therefore, to demand access to any information that they may deem necessary to fulfill their managing and monitoring duties. A director's role in the corporation, when accessing information to support decision making, should not be diminished with a lower standard of care. Admittedly, using presumed access to information as a reason for differentiating officers from directors has a superficial appeal because officers are involved in day-to-day operations; however, upon closer examination, the information gap—if there is one—is an unpersuasive point of differentiation when the realities of access to information are considered.

31. Edward Rock & Michael Wachter, *Dangerous Liaisons: Corporate Law, Trust Law, and Interdoctrinal Legal Transplants*, 96 Nw. U. L. Rev. 651, 667 (2002).

32. John W. Payne, James R. Bettman & Mary Frances Lane, *When Time Is Money: Decision Behavior Under Opportunity-Cost Time Pressure*, 66 Organizational Behav. & Hum. Decision Processes 131, 133 (1996), *available at* http://www.faculty.fuqua.duke.edu/~jrb12/bio/Jim/46.pdf ("Research suggests three major ways in which people respond to decision problems under time pressure. First, people accelerate their processing (i.e., spend less time processing each item of information). . . . Second, processing tends to be more selective under time stress, focusing on the more important and/or negative information about alternatives. . . . Third, decision strategies may shift as a function of increased time pressure." (internal citations omitted)).

33. Max H. Bazerman, Judgement in Managerial Decision Making 9 (1st ed. 1986) ("This analysis suggests that complete information will not always be available to the decision maker at any given decision point.").

Sparks and Hamermesh echo Johnson's position when they state that "because a president generally is charged with a particularly high degree of corporate familiarity, the resultant liability to the company or its stockholders is more extensive than that of a mere director."[34] Unfortunately for this line of reasoning, the "mere" directors are charged with managing the corporation.

C. Compensation

Johnson asserts that:

> Overall, executive officers receive higher absolute levels of pay than do directors, and a significant portion of that pay is—or at least is designed to be—based on performance. In short, officers, unlike directors, stand to reap substantial rewards for taking appropriate risks. Thus, even if the risk element is the same as for directors, the reward element is quite different, thereby substantially altering how an officer—in comparison to a director—makes this calculation.[35]

In support of this position he states: "If the standard of care [ordinary negligence] is thought to be too onerous to induce people to work, then apparently none of us would work, whether in professions, trades, manufacturing, or other jobs where ordinary care is the conventional standard of conduct."[36] Citing a leading treatise on corporate law, Sparks and Hamermesh report:

> It also has been said that the duties of active officers of a corporation who devote all or most of their time to a corporation's business and who receive a salary as officers, are more extensive than those of directors who do not give the corporation daily attendance and who receive little or no salary.[37]

It is interesting to note that Johnson equates officers with professionals—presumably doctors and lawyers—for purposes of responsibility and liability, but excuses so-called "professional" directors[38] from the same standard as other professionals because directors are not paid as much and because serving as a director is not a full-time job.[39] Again, the standards for differentiation are unconvincing. It is shortsighted and simplistic to assign responsibility based on compensation alone. Is an officer who is paid a salary of $100,000 less culpable than an officer paid $300,000? And, in like manner, should a director receiving

34. Sparks & Hamermesh, *supra* note 29, at 219.
35. Johnson, *supra* note 1, at 459 (footnotes omitted).
36. *Id*. at 460.
37. Sparks & Hamermesh, *supra* note 29, at 219 (citing 3 Fletcher Cyclopedia of the Law of Private Corporations § 991 (perm. ed. 1986)).
38. *See generally* Graf, *supra* note 22.
39. Johnson, *supra* note 1, at 460 ("Officers work for the company full time, possess extensive knowledge and skill concerning company affairs, have access to considerably more and better information than directors, enjoy high company and social status, and exercise great influence over the lives of many people—both inside and outside the corporation. They should be held to the same standard of care as are all other persons who serve as agents of companies—a duty of ordinary care."). It is important to note, however, that "directors as well as officers receive incentive compensation, in several forms." Hamermesh & Sparks, *supra* note 2, at 871.

total compensation of $300,000 per year have greater potential liability than a director receiving $30,000?

This line of reasoning is a slippery slope that leads to arbitrary, unjust results. Regardless of how much total compensation directors receive relative to officers, it does not change the fact that directors have primary responsibility for managing the corporation. Primary responsibility is inconsistent with secondary accountability.

D. Time Commitment

Equally disturbing is lowering the standard for director performance because officers have full-time positions and a directorship is a part-time job. A director's fiduciary duty of care in monitoring business operations should not be watered down based on the amount of time spent by the director. Directors must be fully committed and focused whether or not they work full time. Being a director may be a part-time job, but it is not a hobby. Furthermore, the current expectation for director engagement and preparation are far greater than in the recent past.[40] It would be an odd juxtaposition if the expectations were going up at the same time that the performance standards were sinking.

Finally, officers do not hold themselves out as independent professionals, like a physician does. Officers do not act independently. All decisions are made within the context of the corporate culture, history, and collective strengths and weaknesses of the business. If either directors or officers must be compared to other professionals, it seems that directors would be the more apt selection.

III. Agency Theory Is a Flimsy Hook on Which to Hang Corporate Officers

Johnson and Millon advocate using agency principles as a basis for differentiating the fiduciary duties of officers and directors. They state:

> [D]rawing on the fiduciary duties of agents for guidance in fashioning modern understandings of corporate officer duties—and differentiating those duties from those of directors—can provide much needed structure to what otherwise threatens to be an ad hoc enterprise. Of course, an agent's fiduciary duties being broadly sketched, they can be given shape and content only in particular contexts.[41]

Johnson was adamant in his insistence that agency theory was the wedge that exposed officers to greater potential liability than directors. For example, he criticized the Minnesota Court of Appeals' application of the business judgment rule to officers in *Potter v. Pohlad* as follows: "Had the court appreciated that officers are not fiduciaries for the same reason as directors, but owe stricter duties due to

40. Graf, *supra* note 22, at 26 ("[A] new set of expectations is emerging for directors, along with demands for a new breed of activist in the boardroom." (quoting Millstein, *supra* note 22, at 1427)).

41. Johnson & Millon, *supra* note 5, at 1601–02.

their agency status, it might have been more reluctant to grant the officer the same highly deferential business judgment review given directors."[42]

However, the court's reluctance to use agency theory to deny officers the protection of the business judgment rule should not have surprised Johnson considering that he also made the following observation:

> Within the field of corporate governance, the undoubted legal status of corporate officers as agents is rarely noted. The agency status of officers seems to be far more significant to the issue of whether, in a particular case, officers have power to affect the corporation's relationship with third parties than to the issue of the fiduciary duties owed by officers, as agents, to their corporate principal. Although the fiduciary status of corporate officers is widely noted, two points about the recognition of that status are conspicuous. First, it is only *rarely grounded on agency principles*. Second, it is not differentiated from the fiduciary status of directors.[43]

Jones fully supports Johnson's assertions regarding the status of officers as agents of the corporation:

> This article assumes that the conceptual basis for officers' fiduciary duties is their status as agents and that agency law provides the starting point for articulating those duties and the standards of review applicable to them. It is beyond doubt that officers are agents of the corporation, so any coherent theory of officer liability must confront that fact.[44]

Indisputably, there is an appealing simplicity to grounding officer liability in notions of agency. Officers are agents.[45] Agents owe a duty of ordinary care to their principals;[46] therefore, officers owe a duty of ordinary care to the corporation. By contrast, following the same line of reasoning, directors technically are not agents of the corporation; therefore, they can be held to a lesser standard of care, namely, gross negligence.

However, there are a few problems with this theoretical syllogism. First, there is no authority for the assertion that officers are exactly like other agents. Second, when officers are described as agents of the corporation, it is in the context of having authority as agents to bind the corporation,[47] not in the context of imposing individual liability on officers for simple negligence.

42. Johnson, *supra* note 1, at 445 (criticizing Potter v. Pohlad, 560 N.W.2d 389 (Minn. Ct. App. 1997)).

43. Johnson & Millon, *supra* note 5, at 1609 (footnotes omitted) (emphasis added).

44. Jones, *supra* note 11, at 483 (footnotes omitted).

45. 3 Fletcher Cyclopedia of the Law of Private Corporations §§ 837.50, 991 (rev. vol. 2010).

46. Restatement (Third) of Agency § 8.08 (2006) ("Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances. Special skills or knowledge possessed by an agent are circumstances to be taken into account in determining whether the agent acted with due care and diligence. If an agent claims to possess special skills or knowledge, the agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents with such skills or knowledge.").

47. *Id.* § 2.02 cmt.

Rock and Wachter warn of the unintended consequences when one body of law is, for convenience, transplanted onto another body of law: "[L]egal transplants, whether from one legal system to another or from one doctrinal area to another, are tricky because of the differences in context. Legal transplants often have difficulty adjusting to a new body of law."[48] Barclift uses the expression "fuzzy logic" when describing a theory that "categorizes concepts or things belonging to more than one group."[49] In other words, does it make sense to conflate officers with other agents, such as lawyers or doctors—who are not necessarily agents either—in concluding broadly that officers must be held to a duty of care standard of ordinary negligence? Or should the realities of being a corporate officer be addressed before woodenly applying an unpersuasive technicality?

For example, if officers are agents, are directors their principals? The answer is clearly no, because the fiduciary duty owed by the agent-officers is to the corporation and its shareholders. One problem with this agency theory is that under agency law agents operate upon the directions of the principal.[50] However, neither the corporation nor the shareholders direct the officers. The directors direct the officers through delegation of authority, but directors are not principals. How, then, to categorize officers properly? They are not agents because the directors are in charge and have the authority to manage the corporation, not take orders from the shareholders on how to manage.

Barclift attempts to explain the theoretical quagmire as follows:

> Senior corporate officers' responsibilities lack clarity within a principal/agent paradigm, which seeks to define all fiduciary duties based on the necessity of implementing agency control costs on behalf of shareholders. Senior officers are not the true agents of shareholders, but are the agents of directors charged with the singular task to steward the best interest of the corporate entity.[51]

The confusion regarding the appropriate label for directors also extends to the law of trustees. Although some courts have referred to directors as trustees,[52] directors are not trustees or advisors.[53] In frustration, I have described a director as a "*rara avis*—a rare bird"—because directors defy definition or categorization.[54] Since directors delegate authority to the officers, are directors a kind of quasi-agent of the corporation acting as a quasi-principal of the officers? Such theoretical gymnastics show that overlaying agency theory on top of corporate governance

48. Rock & Wachter, *supra* note 31, at 671.

49. Barclift, *supra* note 16, at 177.

50. Restatement (Third) of Agency § 2.01 (2006) ("An agent acts with actual authority when, at the time of taking action that has legal consequences for the principal, the agent reasonably believes, in accordance with the principal's manifestations to the agent, that the principal wishes the agent so to act.").

51. Barclift, *supra* note 16, at 187.

52. Graf, *supra* note 22, at 35 ("[D]irectors of a corporation are trustees for the stockholders and their acts are governed by the rules applicable to such a relation . . . ." (quoting Finch v. Warrior Cement Corp., 141 A. 54, 63 (Del. Ch. 1928))).

53. *Cf. id.* at 36.

54. *Id.* at 25.

is a dangerous and confusing game. Also, agency is a contractual relationship.[55] Although it is possible for senior officers to be under contract, most officers have no contract with the corporation. Job descriptions do not constitute contracts.

Johnson's analysis of the agency obligations of officers is not as neat as he suggests. As a result, reflexive application of the *Restatement (Third) of Agency* to officers is inappropriate without context. Rock and Wachter describe the difficulty of judges enforcing a negligence standard on corporate officers as follows:

> To rest liability on the presence or absence of negligence when judges cannot reliably distinguish between negligent and non-negligent behavior causes a host of problems. First, decisions by the central managers of firms often mean that someone is disappointed. If that someone can either reverse the decision by appeal to an outside party, or use the appeal to an outside party to impose costs on other insiders, the internal balance will be upset. In addition, courts with inferior information will do systematically worse than the internal governance mechanism in adjudicating the merits of a dispute. Even worse, by allowing disappointed parties to appeal outside, the structure that forces the parties to work out their differences internally is impaired.[56]

The blind application of an ordinary negligence standard to officers because of the so-called demands of agency law is overly simplistic and glides over the difficulties of determining negligence in a complex organization.

IV. The Business Judgment Rule and Officer Decision Making

Johnson argues that the business judgment rule, "a cornerstone of corporate law," should not be extended to corporate officers in the same broad manner in which it applies to directors.[57] He opines that this result is "fitting given the central roles played by officers in our corporate system and given that most of the recent corporate scandals involved significant wrongdoing at the officer level."[58] However, Johnson also concedes that courts should not use 20/20 hindsight to second-guess the substantive soundness of officer decisions.[59] He, nevertheless, believes that an officer's duty of care demands that the courts inquire into whether officers fully discharged their duty of care in "preparing for, making, and carrying out the business decision."[60] In other words, he separates the decision itself from the process used to make the decision. Hamermesh and Sparks agree with Johnson that the business judgment rule should not provide an "underserved refuge" for officers,[61] but they are skeptical whether judicial scrutiny into preparing for, making, and carrying out business decisions would not risk the same hindsight bias.[62]

55. Restatement (Third) of Agency § 8.07 (2006) ("An agent has a duty to act in accordance with the express and implied terms of any contract between the agent and the principal."); *see also* Sparks & Hamermesh, *supra* note 29, at 222 ("A fundamental tenet of agency law is that the extent of the agent's duty to the principal is generally determined by the parties' agreement.").

56. Rock & Wachter, *supra* note 31, at 667.

57. Johnson, *supra* note 1, at 440.

58. *Id.* at 441.

59. *Id.* at 452.

60. *Id.* at 463.

61. Hamermesh & Sparks, *supra* note 2, at 866.

62. *Id.* at 873–74.

Unfortunately, the Delaware Supreme Court only narrowly addressed officer liability in *Gantler v. Stephens*.[63] As stated earlier, the court held that officers owe fiduciary duties identical to those of directors, but it did not say whether officers were entitled to the same protective presumptions of the business judgment rule, nor did it clarify if officers would be held to a standard of simple negligence in duty of care cases, when directors, by contrast, are held only to the lesser standard of gross negligence. The court did note that the consequences of a fiduciary breach by officers might be more severe because they cannot currently be exculpated in the same manner as directors.[64] There is no authority for concluding, however, that the lack of an exculpation statute implies that officers should be held to a higher standard. Even though the case law on the application of the business judgment rule to officers is sparse, no court has held that the business judgment rule does not apply to officers, and several courts have held that it does.[65]

Hamermesh and Sparks appear to have the better argument for the application of the business judgment rule to officers. There is nothing to prevent a court from using hindsight to determine if an officer either breached the duty of care in preparing for, making, and carrying out business decisions or to separate the so-called "substance" of the decision from the process leading up to the decision. The decision regarding the time and resources dedicated to information-gathering processes to support the decision is, itself, a substantive decision. Officers who must make decisions in real time are often pressed to commit to a decision without the benefit of all information that could be gathered if the timing were different. A judge's decision on the nature of the information-gathering process will, necessarily, require the judge to exercise hindsight. Bifurcating "process" from "substance" will not change this result. Furthermore, both the process and the ultimate decision are part of a continuum that does not lend itself to selective dissection.

In *Smith v. Van Gorkom*, the court held that the process followed by the Trans Union board to determine the value of Trans Union stock was a breach of the director's duty of care.[66] However, drawing a line that enables courts to consider process failures but prohibits them from second-guessing decisions makes more sense in theory than in practice. Both elements are part of the decision-making process. Therefore, courts should be as cautious in second-guessing the decision-

63. 965 A.2d 695, 708–09 (Del. 2009).

64. *Id*. at 709 n.37 (referring to section 102(b)(7) which permits corporations to adopt a provision in their certificate of incorporation exculpating directors from monetary liability for an adjudicated breach of the duty of care).

65. Hamermesh & Sparks, *supra* note 2, at 869; *see, e.g.*, Potter v. Pohlad, 560 N.W.2d 389, 391–92 (Minn. Ct. App. 1997) (applying the business judgment rule to officers); Selcke v. Bove, 629 N.E.2d 747, 750 (Ill. App. Ct. 1994) ("Plaintiff's position that the business judgment rule does not apply to corporate officers is unsupported by Illinois law and . . . is against the substantial weight of judicial authority from other jurisdictions on the issue. As such, we decline to adopt that position.").

66. 488 A.2d 858, 872–73, 881 (Del. 1985) ("[A] director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. . . . We conclude that Trans Union's Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal on September 20.").

making process as they are with respect to second-guessing the decisions flowing from the process.

If, as I recommend, courts leave the decision-making process to officers and directors, then the only way for courts to find a breach of the duty of care in decision making would be if the decision were irrational. It seems, however, that even this is problematic. What seems irrational in retrospect may not have seemed so during the heat of the moment. Also, notions of irrationality will frequently require a discussion of the appropriate level of risk. A risky venture may seem irrational to a court in retrospect—especially if the company lost money—but courts should not be in the business of determining appropriate risk parameters. Risk management is peculiarly a function of the officers and directors. Furthermore, if a judge questions the rationality of a decision because it is clearly beyond the bounds of reason, it is more likely that the duty violated was the duty of loyalty, not the duty of care.

A more basic question is whether it is reasonable to expect corporate officers and directors to be rational. This may appear at first blush to be an odd question, but studies indicate that true rationality is never achieved.[67] An even more difficult question is whether rationality in the context of ordinary negligence is different from rationality in the context of gross negligence. In other words, must officers do more information gathering than directors in order for their decisions to be rational, since directors' rationality is based on a lesser degree of due diligence? The suggestion that officers must be more rational than directors seems inherently wrongheaded.

Max Bazerman states that decision makers have "bounded rationality."[68] The bounded-rationality theory views individuals as attempting to make rational decisions, but falling short of rationality for a variety of reasons. For example, Bazerman states:

> [T]ime and cost constraints limit the quantity and quality of available information. . . . [D]ecision makers retain only a relatively small amount of information in their usable memory . . . and limitations on intelligence and perceptions constrain the ability of decision makers to accurately "calculate" the optimal choice from the information that is available.[69]

Bazerman concludes: "Together, these limitations prevent decision makers from making the optimal decisions assumed by the rational model. The irrational decisions that result typically reflect a reliance on intuitive biases that overlook the full range of possible consequences."[70]

67. *See, e.g.*, Michael E. Murphy, *The Nominating Process for Corporate Boards of Directors: A Decision-Making Analysis*, 5 BERKLEY BUS. L.J. 131, 151, 160–61 (2008); S. Trevis Certo, Brian L. Connelly & Laszlo Tihanyi, *Mangers and Their Not-So Rational Decisions*, 51 BUS. HORIZONS 113, 115 (2008); Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 690–93 (2005).

68. MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 6 (6th ed. 2006).

69. *Id.*

70. *Id.*

Furthermore, Bazerman states that "researchers have found that people rely on a number of simplifying strategies, or rules of thumb in making decisions. These simplifying strategies are called heuristics. As the standard rules that implicitly direct our judgment, heuristics serve as a mechanism for coping with the complex environment surrounding our decisions."[71]

Surprisingly, Bazerman also states that even "very smart people" systematically deviate from rationality by inappropriately applying heuristics to make decisions because of cognitive bias[72] and bounded awareness.[73] If "very smart people" are handicapped by bias and perceptual limitations, it seems that courts may want to reevaluate conceptions of "rationality" in the officer and director liability context.

Apart from bias and faulty heuristics, there are other universal problems that adversely affect the decision-making process. Brain function expert David Rock states that "[m]aking complex decisions and solving new problems is difficult for any stretch of time because of some real biological limits on your brain."[74] Rock continues: "We have a limited bucket of resources for activities like decision-making . . . and when we use these up, we don't have as much for the next activity."[75] Thus, "[m]ake one difficult decision, and the next is more difficult."[76]

Rock writes metaphorically that the decision-making function of the prefrontal cortex is a small stage where actors play a part. The audience represents the decision maker's inner world of thoughts, memories, and imaginings. The stage is arrayed with actors who represent whatever the decision maker focuses on at any point in time. To make a decision, he holds actors onstage and compares them to one another in making value judgments. If he recalls information, he brings the appropriate audience member onto the stage. If the memory is old, then the audience member must be brought from the dark at the back of the audience. At times, the decision maker must not focus on an actor or keep the actor off the stage—such as when facing a deadline.[77]

Rock's metaphor can be applied to officer decision making. Officer access to mountains of information will not ensure the quality of decision making unless relevant data is available in the prefrontal cortex so that it can be factored into the

71. *Id.* at 7.

72. Cognitive bias include such things as "presumed associations," "insensitivity to sample size," irrational "anchoring," giving great weight to present concerns over future concerns, making decisions based on emotional reactions, looking solely for data that confirms preconceived notions, and giving undue weight to vivid or recent information, among others. *Id.* at 18–40.

73. Bounded awareness examples include inattentional blindness (intense focus causes one to miss); change blindness (when something happens one step at a time, one is less likely to notice); focalism (focusing on one event and not others that are occurring contemporaneously); and bounded awareness in groups (bounded by the information that becomes part of the discussion, not including other information known by the group members). *Id.* at 167–87.

74. David Rock, Your Brain at Work: Strategies for Overcoming Distraction, Regaining Focus, and Working Smarter All Day Long 1 (2009).

75. *Id.* at 9 (quoting Dr. Roy Baumeister, member of the social psychology faculty at Florida State University).

76. *Id.*

77. *Id.* at 7–8.

decision. Frequently, corporate officers must weigh competing interests to reach a rational decision. A prior discussion of the pros and cons of an issue, stored in the officer's memory, is useless unless it is subsequently reactivated and brought center stage to be considered along with other issues when the ultimate decision is made. For example, an officer who is briefed on economic forecasts, but neglects to recall the data to the prefrontal cortex when making a decision, arguably fails the rationality standard. This might be referred to as making a decision in a vacuum. Relying on the assumed contribution of the subconscious memory or on intuitive gut feelings to support conscious decision making is relying on shadows to illuminate the process.

Another problem with evaluating an officer's decision-making process in hindsight is that, as stated above, such decisions are not made in a vacuum. In most situations, the officer will have consulted with experts within the company or used a committee or team[78] to assist with the process of gathering information and weighing alternatives. This reality of corporate decision making raises a number of complicating factors for the judiciary. If a committee that is chaired by an officer uses a faulty decision-making process, or if the committee arrives at an irrational decision, are all the committee members liable or just the chairman/officer? Also, even though officers are full-time employees, they will frequently consult with others. In so doing, as part of the decision-making process, the officer might rely on the input from the expert. Are officers entitled to reasonably rely on the input in the same manner as directors?[79] Similarly, if an officer delegates decision making to one of the officer's staff, in the same manner as the board delegates to the officer, does the officer retain liability if a judge determines that the staff decision was irrational, or the process used was lacking?

Even if the courts conclude that officers are entitled to the protective presumption of the business judgment rule, the prospect of liability based on faulty decision

78. Anyone who has worked with a committee or team will agree that the processes and practices of either are frequently badly flawed for a variety of reasons. *See generally* Becky L. Nichol, *Top Ten Reasons Teams Become Dysfunctional*, NAT'L PUB. ACCT., Feb. 1, 2010, at 12; HARVEY A. ROBBINS & MICHAEL FINLEY, THE NEW WHY TEAMS DON'T WORK: WHAT GOES WRONG AND HOW TO MAKE IT RIGHT 33–173 (2002).

79. *See* DEL. CODE ANN. tit. 8, § 141(e) (2001) ("A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation."). This section states that directors may reasonably rely on reports and experts. I question whether a director can reasonably rely on reports and experts if the director is not familiar with the affairs of the corporation.

Additionally, Hamermesh and Sparks quote a comment to the Model Business Corporation Act saying that an officer's "ability to rely on information, reports, or statements, may, depending upon the circumstances of the particular case, be more limited than in the case of a director in view of the greater obligation he may have to be familiar with the affairs of the corporation." Sparks & Hamermesh, *supra* note 29, at 218 (quoting MODEL BUS. CORP. ACT § 8.42 cmt.). The comment quoted by Hamermesh and Sparks may have been true twenty years ago, but in this era of enhanced governance practices, it may no longer be the case.

making should give officers pause. Even if judges refuse to exercise 20/20 hindsight in second-guessing the ultimate decision, judicial scrutiny of the decision-making process is equally objectionable. And, when the biological and psychological challenges to effective decision making are factored into the equation, there are ample reasons for the courts to exercise extraordinary discretion before projecting themselves into corporate operations.[80]

Additionally, there is reason to believe that fear of crippling liability for decision-making shortcomings could result in risk adversity that may not be in the best interests of shareholders. Johnson stated that directors "are said to need liability protection to induce risk taking because [they have] relatively small stock holdings," and therefore lack the "upside" incentives that could cause them to take unreasonable risks in the hopes of a large payoff.[81] In contrast, he states that "executive officers receive higher absolute levels of pay than do directors," and the different risk/reward ratios justify holding officers to a higher standard.[82] In other words, he advocates a higher standard for officers because the "reward element" of the risk/reward ratio is "quite different" for officers, and "officers, unlike directors, stand to reap substantial rewards for taking appropriate risks."[83]

Hamermesh and Sparks find Johnson's arguments on this point to be unpersuasive because both officers and directors receive incentive compensation, which relegates any difference to a matter of degree.[84] Furthermore, they suggest that the potentially catastrophic liability claims against officers would counterbalance the greed factor.[85]

Their approach is more realistic because Johnson ignores the fact that the board is responsible for setting risk parameters for the corporation. If a rogue officer takes unreasonable risks, then the board is at least partly to blame for failing to monitor him. Johnson also bypasses the reality that officers face immediate expulsion by the board for reckless conduct. Before an officer would go off on a risky personal treasure hunt, she would, no doubt, factor in her corporate mortality. Also, although directors may not have the same degree of compensation upside as senior officers, it would be a mistake to imply that directors are not well compensated. Many directors receive a significant portion of their compensation in the form of incentive compensation. For example, in 2009, non-management directors at General Electric Company received average

80. Some may question whether the analysis of officer negligence should also apply to other kinds of negligence such as medical malpractice or a rear-end collision. It should not, because officer negligence is distinguishable from other forms of negligence. Officer decisions are not easily categorized as rationally right or wrong without the exercise of 20/20 hindsight. Plus, officers are expected to take appropriate risks even though some risk taking may result in loss to the corporation. On the other hand, the rationality of physician and driver conduct can be tested against established standards of practice without hindsight. If a physician wants to deviate from the standards, then patient consent is required.

81. Johnson, *supra* note 1, at 458.

82. *Id*. at 459.

83. *Id*.

84. Hamermesh & Sparks, *supra* note 2, at 871.

85. *Id*.

annual compensation of just over $356,000; more than half of that average sum was incentive compensation.[86]

V. Who Is an "Officer" for Purposes of Officer Liability?

The generic expression "officers" could be applied to a large number of employees in many corporations. For example, a large bank might have hundreds of officers based on their title. On the other hand, other "flatter" corporations may refer to all employees as associates (or some other terminology of equality) rather than use titles. Still other corporations, more pyramid in structure, may have only a few officers who would be subject to liability.

It is unlikely that Johnson intends for all employees carrying an "officer" title to be treated the same for liability purposes. For example, he sometimes uses the expression "executive officer" in addition to "officer."[87] That reflects an attempt to differentiate the class of "officers" into subgroups for liability purposes. Presumably, he intends for greater potential liability to be meted out to senior officers who exercise more managerial control and who have marginally more to gain from taking unreasonable risk.

Likewise, Hamermesh and Sparks make a distinction between officers having different characteristics. For example, they use modifiers such as "superior officers."[88] Furthermore, they question whether the use of a title makes any logical sense: "A title is not dispositive. For example, a business manager is not necessarily an officer, nor is a vice president for sales necessarily an officer whose appointment or removal requires board action."[89] Therefore, "[t]he term 'officer' is properly applicable only to those in whom administrative or executive functions have been entrusted, and does not apply to those without judgment or discretion as to corporate matters."[90] In an effort to clarify the difference between administrative and executive functions, they state that "[a]n individual expressly designated as an officer by the board of directors should . . . be presumed to be empowered to exercise judgment and discretion as to corporate matters, unless it is shown that the board did not intend to vest such authority."[91]

The foregoing attempts to define "officer" for purposes of officer liability do more to highlight the problem than to ameliorate it. All corporations have employees with varying degrees of discretion who exercise judgment with respect to decisions. Even the employees on the lower end of the pay spectrum have a certain amount of discretion in the performance of their jobs. If all employees in a

86. Gen. Elec. Co., Notice of 2010 Annual Meeting and Proxy Statement 39–41, *available at* http://www.ge.com/investors/financial_reporting/proxy_statements.html.

87. *See* Johnson, *supra* note 1, at 459.

88. Hamermesh & Sparks, *supra* note 2, at 876 ("[A]n officer should not ordinarily be protected by the business judgment rule with respect to conduct that contravenes policies or directives established by the board of directors or by superior officers implementing board policy.").

89. Sparks & Hamermesh, *supra* note 29, at 216–17 (footnote omitted).

90. *Id.* at 216 (footnote omitted).

91. *Id.*

corporation were placed on a scale based on the level of discretion vested in them by the board, their supervisor, or their job description, at what point would the line be drawn so that those above the line were "officers" subject to liability for breaches of the duty of care? Employees with impressive sounding titles could be low on the scale because their jobs are more titular than functional.

There are numerous practical difficulties with this kind of uncertainty. The most important is that an officer would not know whether she was an officer for liability purposes until a court made that determination. Considering the potential dysfunction wrought by the uncertainty, this sort of arrangement is untenable in the real world of running a business.

In his tirades against the business scandals, Johnson saves his venom for the most senior company officers.[92] For example, when he references a Towers Perrin study about corporate compensation, he notes that "the annual bonus of a U.S. CEO averaged fifty-six percent of salary" and that "[o]verall, *executive* officers receive higher absolute levels of pay than do directors."[93] He is obviously directing his comments most pointedly at officers on the senior management team, such as the CEO, CFO, and general counsel. Barclift likewise, whether intentionally or not, frequently interchanges "officer" with "senior officer."[94]

These references by commentators to the most senior officers who are vested by the board with the most discretion should, perhaps, be deemed an acknowledgement that only the most senior officers should be targeted by any officer-liability analysis. This would comport with the treatment of the CEO and CFO under the Sarbanes-Oxley Act, which requires those officers to certify the accuracy of the financial statements.[95] If Delaware courts decide to impose a form of officer liability, it is incumbent on the courts to specify precisely which officers are at risk for personal liability, and how they can be identified.

VI. Effects

Before any officers are subjected to personal liability for breach of the fiduciary duty of care, it is prudent to consider the likely effects of the risk of liability on

92. *See, e.g.*, Johnson & Ricca, *supra* note 1, at 665–69 (focusing on CEO and director-level employees).

93. Johnson, *supra* note 1, at 459 (emphasis added).

94. Barclift, *supra* note 16, at 180–82.

95. Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006). According to this section,

> The Commission shall, by rule, require, for each company filing periodic reports under section 13(a) or 15(d) of the Securities Exchange Act of 1934, that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of such Act that—(1) the signing officer has reviewed the report; (2) based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading . . . .

Id.

corporate governance. Contrary to Johnson's analysis, the risk of liability would make officers more risk averse. Why would officers subject themselves to extraordinary damages when they could evade liability by playing it safe? Johnson counters that officers are more concerned with maximizing wealth than worrying about liability. However, unless officers can be insulated from personal liability for breaching the duty of care like directors, Johnson overstates the case.

Officer liability would likely stimulate other counterproductive conduct. Discretionary authority would be buried under layers of committee groupthink so that the trail of responsibility would not lead to any one individual. Every officer would engage in scapegoat hunting to distance himself from the ultimate decision. Instead of doing what is best for the corporation, the officer's focus would be on developing a bullet-proof narrative to deflect any attributions of fault. Either decision-making responsibility would be hidden in a maze of corporate bureaucracy, or it would be pushed back onto the board.[96] In other words, the judicial cure for officer malfeasance would likely be far worse than the disease. Is there a way to solve the problem without killing the patient?

VII. Suggestions

A. Fear Factor

Although very few judgments have been rendered against corporate directors in the aftermath of *Smith v. Van Gorkom*,[97] it is indisputable that the case has had a beneficial effect on the behavior and effectiveness of boards. Even with the protections of the business judgment rule, the chilly winds of *Smith v. Van Gorkom* still blow through the boardroom. Directors realize that they are subject to scrutiny and cannot act against the interests of the corporation with impunity.

In like manner, it would be good for corporate officers to experience their own *Smith v. Van Gorkom* moment. Their awareness of the specter of potential liability may have positive effects provided that it does not induce unwanted behavior. It must be made clear that the business judgment rule protects officers in the same way that it has shielded directors. Hindsight bias applies as equally to officers as it does to directors. Judicial restraint in reviewing substantive decisions should apply equally to process decisions as to substantive decisions.

If so limited, the only judicial review of director or officer behavior under the duty of care rubric would involve irrational actions involving reckless indifference or intentionally destructive conduct. Arguably, actions based on recklessness or destructive conduct must be based on a breach of the duty of loyalty. As a result, other duty of care issues would be handled internally. Corporations are better

96. *See* Hamermesh & Sparks, *supra* note 2, at 875.

97. Charles W. Murdock, *Corporate Corruption and the Complicity of Congress and the Supreme Court—The Tortuous Path from* Central Bank *to* Stoneridge Investment Partners, 6 Berkeley Bus. L.J. 131, 150 (2009) ("While directors and their political allies constantly cry about the specter of litigation, the foregoing gestalt is not one that should strike fear in the heart[] of a reasonable director. The likelihood of liability is extremely remote." (footnote omitted)).

situated than a judge to determine appropriate remedial action in response to officer or director negligence.

B. Duty of Loyalty

If, as has been suggested, judicial review of officer and director duty of care cases is limited to those situations involving reckless or intentional violations, then for clarity the duty of care should be subsumed under the duty of loyalty in the same way that the Delaware courts have made the duty of good faith "a subsidiary element" of the duty of loyalty.[98] If the duties of officers and directors can be stated simply as doing what is in the best interests of the corporation, then the duty of loyalty would cover all conduct that was not in the corporation's best interests, whether or not such conduct has in the past been characterized as a breach of the duty of care or of good faith. Johnson and other commentators frequently use expressions such as "wrongful" or "wrongdoing" in connection with duty of care analysis.[99] This is an acknowledgement that fiduciary duties should be grouped under the duty of loyalty and that the focus should be on conduct that is wrongful in that it is not motivated by regard for the best interests of the corporation.

C. Decision Making

Judges should limit the scope of their review of corporate decision making, whether of the ultimate decision or the process used to arrive at that decision. This would recognize that both the decision and the process for arriving at the decision necessarily involve hindsight bias. Furthermore, courts should be very hesitant to stand in judgment of the rationality of decisions. As demonstrated in this article, rationality is in the eye of the beholder, and all decision makers are victims of bias and other heuristics that impact the pure rationality of decisions. Therefore, courts should only become involved in corporate decision making when there are allegations of intentional or reckless misconduct.

D. Section 102(b)(7)

The reasons for allowing corporations to insulate directors from monetary damages for a breach of the duty of care apply equally to officers. Officers must have the same freedom to determine appropriate risk levels and pursue opportunities

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98. Stone *ex rel*. AmSouth Bancorporation v. Ritter, 911 A.2d 367, 370 (Del. 2006) ("The requirement to act in good faith 'is a subsidiary element[,]' i.e., a condition, 'of the fundamental duty of loyalty.'" (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)) (alteration in original)).

99. *See, e.g.*, Johnson, *supra* note 1, at 464 ("[D]irectors, upon learning of fiduciary wrongdoing by a corporate officer, must investigate and decide whether to pursue a claim by means of litigation, or to resolve it through imposing an intra-firm sanction or by reaching a negotiated settlement."); Jones, *supra* note 11, at 475 ("In addition to high-profile corporate implosions tainted by officer misconduct, the corporate governance community has focused greater attention on corporate compensation, including the payment of substantial severance packages to departing executives who have engaged in wrongdoing . . . .").

without fear of judicial second-guessing. Such insulation would not, however, shield officers from breaches of the duty of loyalty.

VIII. Conclusion

Officer liability is a topic that has not received enough judicial and legislative attention. After *Gantler v. Stephens*,[100] important issues regarding officer liability remain unresolved. Instead of overreacting to recent corporate malfeasance, it is time to define officer liability in a realistic and balanced manner that will promote good corporate governance and the preservation of shareholder value.

William Allen, Jack Jacobs, and Leo Strine make an important distinction between standards of conduct and standards of review: "Standards of conduct are sometimes referred to as 'conduct rules' that are addressed to corporate directors and officers, whereas standards of review are 'decision rules' that are addressed to judges."[101] Part of developing a cohesive doctrine is to determine which issues of officer liability should be designated conduct rules—and thus handled internally—and which issues should be resolved judicially. "[F]iduciary duties are rooted in the obligation of the agent to have undivided loyalty and attention to the affairs of the [shareholders]."[102] Courts should focus on breaches of the duty of loyalty and leave internal corporate governance mechanisms to handle decision making and negligence-based issues. Johnson was right to direct attention to officer shortcomings in the aftermath of the recent meltdown, but his insistence on draconian penalties would do more harm than good.

100. Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

101. William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 Bus. Law. 1287, 1295 (2001).

102. Barclift, *supra* note 16, at 181–82.

Charging Order Exclusivity: A Pragmatic Approach to *Olmstead v. Federal Trade Commission*

*J. William Callison**

This article analyzes Olmstead v. Federal Trade Commission, *the recent Florida Supreme Court case concerning whether a charging order is the exclusive remedy by which a member's creditor can obtain the member's interest in a Florida single member limited liability company. It concludes that the* Olmstead *holding—that the charging order is non-exclusive—is grounded in historical "pick-your-partner" principles. It then suggests a framework for balancing creditors' rights and member autonomy principles in limited liability companies and other unincorporated business organizations.*

In *Olmstead v. Federal Trade Commission*, the Florida Supreme Court responded to the question "[w]hether Florida law permits a court to order a judgment debtor to surrender all right, title, and interest in the debtor's single-member limited liability company to satisfy an outstanding judgment."[1] The court considered whether the charging order provisions of the Florida Limited Liability Company Act are exclusive, and concluded that they are not.[2] As a result, the court held that the Florida Limited Liability Company Act does not preclude a member's judgment creditor from executing on a member's full interest; the creditor need not obtain a charging order against the member's right to limited liability company ("LLC") distributions as, when, and if made.[3] It is notable that the court did not hold that the FTC could execute on the member's non-economic interests or what the effect of such execution would be.

In the federal court action, the Federal Trade Commission ("FTC") had obtained a $10 million judgment against Shaun Olmstead and Julie Connell and sought to collect it from the assets of their Florida single member LLCs.[4] The Florida LLC Act expressly permits a LLC member's judgment creditors, like the FTC, to reach the member's *membership interest* in the LLC through a device, borrowed from general

* Partner, Faegre & Benson LLP, Denver, Colorado. I thank Carter G. Bishop, Daniel S. Kleinberger, and Thomas E. Rutledge for their insights and Kara Lyons for her research assistance.

1. 44 So. 3d 76, 78 (Fla. Sup. Ct. 2010). The U.S. Court of Appeals certified a similar question to the Florida Supreme Court, and the Florida Supreme Court rephrased the question.
2. *Id*. at 81–83.
3. *See id*.
4. FTC v. Olmstead, 528 F.3d 1310, 1312 (11th Cir. 2008).

partnership law, called a "charging order."[5] However, the Florida LLC Act, like other state LLC statutes, does not provide the remedy the FTC sought—namely, execution against the member's full rights in the LLC, including rights other than the member's economic rights. These non-economic rights include management participation, voting, and agency powers.[6] Consequently, the charging order is a weak remedy when the LLC does not generate revenues for distributions or when the LLC's management determines not to make distributions.[7] In such cases, charging orders leave the members' creditors waiting for distributions that likely never will come.[8]

This problem is compounded in single member LLCs, which are often used for asset protection purposes and to which members can contribute assets (such as vacation homes) that generate little or no economic benefit but which may have significant value. Simply put, in *Olmstead*, the FTC, acting as creditor, wanted to step entirely into the petitioners' shoes with respect to their single member LLCs, presumably because it thought it could exercise management and other member powers to enhance its position by causing distributions, liquidating the LLCs' assets, or in other ways. To do this, the FTC needed a more robust remedy than a charging order, giving rise to the question addressed to the Florida Supreme Court. Ultimately, the court held that the Olmsteads must sign over to the FTC all "right, title, and interest" in each of their single member LLCs.[9]

In addition to allowing a potentially effective alternative to "reverse veil piercing"[10] and dealing a blow to those using single member LLCs as asset protection devices, the *Olmstead* holding raises a host of complex issues. These issues include the following:

(1) whether the case's reasoning is limited to LLCs with one member, and if not, how it applies to multiple member LLCs;

(2) how one defines a "single member" LLC or, alternatively, expands the court's holding in a universe where LLCs can be formed in a large variety

5. Fla. Stat. Ann. § 608.433(4) (West 2007) ("On application to a court of competent jurisdiction by any judgment creditor of a member, the court may charge the limited liability company membership interest of the member with payment of the unsatisfied amount of the judgment with interest . . . .").

6. *See id.* § 608.422 (management), § 608.4231 (voting), § 608.4325 (agency).

7. *See* Daniel S. Kleinberger, *The Plight of the Bare Naked Assignee*, 42 Suffolk U. L. Rev. 587 (2009).

8. "Nothing to be done." Samuel Beckett, Waiting for Godot act 1 (1949) (Estragon's opening line in the first act).

9. Olmstead v. FTC, 44 So. 3d 76, 83 (Fla. Sup. Ct. 2010).

10. "Reverse veil piercing" is an approach where creditors of an owner seek payment from entity assets. It is the reverse of "veil piercing" where entity creditors seek payment from owner assets. *See* Carter G. Bishop, *Reverse Piercing: A Single Member LLC Paradox*, 54 S.D. L. Rev. 199, 229–30 (2009) ("Generally, typical corporate veil piercing applied to a limited liability company permits an entity creditor to press its claims against the entity owner. A related but rarely used doctrine referred to as reverse veil piercing reverses the process and seeks to impose the entity owner's obligations against the entity's assets."); Larry E. Ribstein, *Reverse Limited Liability and the Design of Business Associations*, 30 Del. J. Corp. L. 199, 216 (2005) ("While standard veil piercing allows an end run around statutory limited liability, or 'defensive asset partitioning,' reverse piercing permits an end run around statutory rules protecting business assets against owners' individual creditors, or 'affirmative asset partitioning.'").

of ways, including with non-economic members, among spouses and with family members, and where some members hold tiny economic interests;

(3) whether charging orders should be an exclusive remedy for a member's judgment creditors in all, some, or no LLCs having multiple members;

(4) what it means to execute on a member's full ownership interest, including whether LLC operating agreements can, or should be permitted to, contractually alter rules that may otherwise apply in favor of members' judgment creditors;

(5) the extent to which *Olmstead* theoretically and practically applies to other entity forms, including general partnerships, limited liability partnerships, limited partnerships, and limited liability limited partnerships; and

(6) whether a statutory resolution to the *Olmstead* issues is desirable and, if so, how it can be accomplished.

After discussing charging orders and the *Olmstead* decision in detail, this article focuses on theoretical and practical responses to *Olmstead*.

I. Charging Orders

A. General Partnerships—Charging Order as Exclusive Remedy

Charging orders, which are part of a complex scheme designed to balance and protect the interests of owners' judgment creditors and the interests of the entity and its other owners, found their first United States statutory iteration in the 1914 Uniform Partnership Act ("UPA").[11] Although charging orders have historically been an obscure remedy, it is likely that the use of the charging order procedure (together with theoretical and practical development of the procedure through

11. *See* Unif. P'ship Act § 28, 6 U.L.A. (pt. II) 341 (2001). Charging orders originated in England, and were first recognized in the English Judgment Acts of 1838 and 1840. *See* Marc Light & Arasto Farsad, *Utilizing the Charging Order*, 35 Lincoln L. Rev. 27, 30 (2007) ("The English Partnership Act of 1890 allowed . . . the charging order remedy for partner creditors to be used against partnership interests in addition to financial interests."); *see also* Daniel G. Kleinberger, Carter G. Bishop & Thomas Earl Geu, *Charging Orders and the New Uniform Limited Partnership Act: Dispelling Rumors of Disaster*, Prob. & Prop., July/Aug. 2004, at 30, 31 ("Section 23 [of the 1890 Act] was intended to protect the business from disruption at the hands of creditors of an *individual partner*. The protection was necessary because of the then prevailing 'aggregate' view of a partnership and the resulting confusion over the rights of partners (and their separate creditors) in partnership property."); Alan M. Weinberger, *Making Partners Pay Child Support: The Charging Order at 100*, 27 Hous. L. Rev. 297, 298–99 (1990) ("[T]he English Partnership Act [of 1890] introduced an entirely new enforcement measure—the 'charging order.' It afforded a partner's judgment creditor recourse against the debtor's partnership interest without disrupting partnership affairs to the detriment of partners unconnected with the debt."). In *Brown, Janson & Co. v. A. Hutchinson & Co.*, the court noted that

> when a creditor obtained a judgment against one partner and he wanted to obtain the benefit of that judgment against the share of that partner in the firm, the first thing was to issue a [writ of execution], and the sheriff went down to the partnership place of business, seized everything, stopped the business, drove the solvent partners wild, and caused the execution creditor to bring

litigation and academic discourse) will increase as LLCs and other unincorporated business organizations continue to become dominant in the United States economy.[12]

UPA section 28(1) provides:

> On due application to a competent court by any judgment creditor of a partner, the court . . . *may charge the interest of the debtor partner with payment of the unsatisfied amount of such judgment debt* with interest thereon; and may then or later appoint a receiver of his share of the profits, and of any other money due or to fall due to him in respect of the partnership . . . .[13]

Although UPA section 28(1) is not entirely clear, courts have held that a judgment creditor with a charging order is generally treated like an assignee of the debtor partner's partnership interest and, as such, is entitled only to current and liquidating distributions actually made by the partnership with respect to the charged interest, but is not entitled to participate in partnership management, demand books and records disclosures, cause partnership dissolution, and have other non-economic rights, including the right to enforce the other partners' fiduciary obligations.[14] The entry of a charging order does not mandate that the partnership make any distributions to the judgment creditor, but merely redirects payments if and as they are made. Under partnership law, a judgment creditor can foreclose on the partnership interest if distributions under the charging order will likely be inadequate to satisfy the judgment within a reasonable time period.[15] However, the purchaser at a foreclosure sale only acquires the debtor partner's economic interest and does not itself become a partner.[16] Without management powers, charging orders frequently have little or no value since there is no clear method for the judgment creditor to force distributions against the will of the other partners or to reach the underlying partnership assets.

> an action in Chancery in order to get an injunction to take an account and pay over that which was due by the execution debtor. A more clumsy method of proceeding could hardly have grown up.

[1895] 1 Q.B. 737 (Eng.). The charging order was designed to create order from chaos. The UPA's creation of the "tenant in partnership" concept worked similar results. *See* UPA § 25, 6 U.L.A. (pt. II) 294 (2001).

12. *See* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 Fordham J. Corp. & Fin. L. 459, 459–60 (2010) ("Rising from near obscurity in the 1990s, the LLC has now taken its place as the new 'king of the hill' among business entities, utterly dominating its closest rivals."); *see also* Howard M. Friedman, *The Silent LLC Revolution: The Social Cost of Academic Neglect*, 38 Creighton L. Rev. 35, 35 (2004) ("The Limited Liability Company ('LLC') has become the dominant form for newly-created small businesses in a clear majority of the states, and is rivaling corporations for that distinction in several more.").

13. 6 U.L.A. (pt. II) 341 (2001) (emphasis added).

14. *See* J.W. Callison & M.A. Sullivan, Partnership Law and Practice: General and Limited Partnerships § 7:20 (1992) (discussing charging orders). Although judgment creditors with charging orders may transfer their rights in a foreclosure sale, these rights are limited to assignee rights. *Id.*

15. *Id.*

16. For a discussion of charging order foreclosure rules as they relate to LLCs, see Thomas E. Rutledge, Carter G. Bishop & Thomas Earl Geu, *Foreclosure and Dissolution Rights of a Member's Creditors: No Cause for Alarm*, Prob. & Prop., May/June 2007, at 35.

The UPA's charging order provision can be viewed as a corollary to the "pick-your-partner" (*delectus personae*, or "choice of person") principle expressed elsewhere in the statute, most notably in the UPA section 27 partnership interest assignment rules:

> A conveyance by a partner of his interest in the partnership does not of itself dissolve the partnership, nor, as against the other partners in the absence of agreement, entitle the assignee . . . to interfere in the management or administration of the partnership business or affairs, or to require any information or account of partnership transactions, or to inspect the partnership books; but it merely entitles the assignee to receive in accordance with his contract the profits to which the assigning partner would otherwise be entitled.[17]

The pick-your-partner principle makes sense against the backdrop of historical general partnership law in which all partners have equal rights in partnership management,[18] all partners have apparent authority to act as agents on behalf of the partnership,[19] all partners have personal liability for partnership debts and obligations,[20] and any partner can cause the partnership's dissolution.[21] By preventing assignees (both voluntary and involuntary) from participating in partnership business, the pick-your-partner principle avoids undue and unbargained-for risk to the partnership business and the other partners posed by the admission of a stranger to the partnership.

Although UPA section 28 does not say that charging orders are the exclusive remedy against partners' partnership interests, a number of courts have so held.[22]

17. UPA § 27(1), 6 U.L.A. (pt. I) 332 (2001).
18. *Id.* § 18(e), 6 U.L.A. (pt. II) 101.
19. *Id.* § 9(1), 6 U.L.A. (pt. I) 553.
20. *Id.* § 15, 6 U.L.A. (pt. I) 613.
21. *Id.* § 29, 6 U.L.A. (pt. II) 349.
22. Although courts have implied that charging orders are the exclusive remedy under the UPA, the various rationales for that conclusion are unclear. Some courts appear to imply exclusivity based on the express language of the partnership statutes, while other courts appear to imply exclusivity based on the conclusion that the UPA supplanted all previous remedies designed to reach a partner's interest in the partnership. However, for the most part, courts state that exclusivity is a well-recognized concept, adding little or no explanation. *See, e.g.*, *In re* Pischke, 11 B.R. 913, 917 (Bankr. E.D. Va. 1981) ("[T]he . . . most logical application is that the Virginia charging order statute supersedes other legislation in the area concerning satisfaction of a judgment creditor's claim against a partner's interest in a partnership."); Evans v. Galardi, 546 P.2d 313, 321 (Cal. 1976) (refusing to adopt "an implied exception to the required use of the statutory charge procedure"); Baum v. Baum, 335 P.2d 481, 483 (Cal. 1959) (concluding that "charging orders on partnership interests have replaced levies of execution as the remedy for reaching such interests"); Atl. Mobile Homes, Inc. v. LeFever, 481 So. 2d 1002, 1003 (Fla. Ct. App. 1986) ("In order to proceed against a debtor/partner, a creditor must obtain a charging order. . . . Even then, the creditor cannot reach partnership assets but can only reach the debtor's share of profits from the partnership. . . . Thus, the statutory charging order is the only means by which a judgment creditor can reach the debtor's partnership interest. . . . Other states which have construed their statutory enactments of the UPA have reached the same result." (citations omitted)); Krauth v. First Cont'l Dev-Con, Inc., 351 So. 2d 1106, 1108 (Fla. Ct. App. 1977) ("At common law [a partnership interest] was subject to levy and sale under execution, but that was changed by the Uniform Partnership Act, which has made the statutory charging order the only means by which a judgment creditor can legally command payment from the debtor's partnership interest."); Myrick v. Second Nat'l Bank of Clearwater, 335 So. 2d 343, 345 (Fla. Ct. App. 1976) ("Other cases under the

The exclusivity of the charging order remedy was widely accepted at common law, and Revised Uniform Partnership Act ("RUPA") section 504(e) ultimately acknowledged the common law of charging orders and provides for "exclusivity" as a statutory matter.[23]

B. Limited Partnerships—Changing Terrain

The Uniform Limited Partnership Act ("ULPA"), promulgated in 1916, similarly provides for the charging order remedy with respect to the interests of limited partners, but states that the remedy "shall not be deemed exclusive of others which may exist."[24] With respect to the interests of general partners, ULPA appears to link to general partnership law, which, as noted above, contains charging order provisions that courts have ruled to be exclusive.[25] Although there is little or no historical analysis of why ULPA made charging orders non-exclusive with respect to creditors of limited partners, it is possible that the ULPA drafters did not think pick-your-partner principles applied with the same force to limited partners as they did to general partners and therefore created a different rule for limited partnership interests.[26]

UPA state that a charging order is the proper procedure to reach the partnership interest."); 91st St. Joint Venture v. Goldstein, 691 A.2d 272, 276 (Md. Ct. App. 1997) ("In the jurisdictions which have adopted § 28 of the UPA, there is general agreement that the charging order is now the judgment creditor's exclusive method of reaching a partner's interest in a partnership and that the creditor may no longer execute directly on partnership property."); Wills v. Wills, 750 S.W.2d 567, 574 (Mo. Ct. App. 1988) ("Under the Uniform Partnership law, therefore, the proper method to 'seize' the interest of an individual partner in a partnership is to apply to the proper court for a charging order . . . ."); *see also In re* Smith, 17 B.R. 541, 547 (Bankr. M.D. Ga. 1982) ("[I]t is clear that the charge order is a substitute for execution, attachment, levy and sale, or garnishment, and that the charge order is the exclusive remedy for a creditor of a limited partner.").

The Florida cases holding that the UPA has an unwritten exclusivity requirement are ironic since the *Olmstead* court held that the lack of a written exclusivity provision in the Florida LLC Act means that charging orders are not necessarily an exclusive remedy. The argument that inclusion of a statutory charging order remedy in the UPA eliminates other remedies is strengthened by the fact that the drafters of the 1916 Uniform Limited Partnership Act specifically provided for nonexclusivity and is weakened by the fact that drafters of the current uniform statutes believed there was a need to state exclusivity. Further, there is no discussion in the case law concerning why inclusion of a limited statutory remedy preempts all other remedies, and the exclusivity holdings seem to follow conventional wisdom. Exclusivity is the logical result of the pick-your-partner principle, expressed in its strongest form in the UPA, rather than an outgrowth of some undeveloped preemption doctrine.

23. Revised Unif. P'ship Act § 504(e) (amended 1997), 6 U.L.A. (pt. I) 160 (2001) ("This section provides the exclusive remedy by which a judgment creditor of a partner . . . may satisfy a judgment out of the judgment debtor's transferable interest in the partnership.").

24. Unif. Ltd. P'ship Act § 22 (1916); *see also Smith*, 17 B.R. at 547. The author has not found any indication of why ULPA diverged from the UPA, but suspects that it might be because the pick-your-partner principle was thought to have less value for limited partners, who lack both the management and agency authority to create obligations for which other partners are personally liable.

25. *See generally* Elizabeth S. Miller, *Linkage and Delinkage: A Funny Thing Happened to Limited Partnerships When the Revised Uniform Partnership Act Came Along*, 37 Suffolk U. L. Rev. 891 (2004); Allan W. Vestal, *A Comprehensive Uniform Limited Partnership Act? The Time Has Come*, 28 U.C. Davis L. Rev. 1195 (1995).

26. Under ULPA, limited partners differ from general partners in many respects.

The Revised Uniform Limited Partnership Act ("RULPA"), promulgated in 1976 and substantially revised in 1985, similarly provides a charging order remedy with respect to partners, but does not state whether the remedy is exclusive or non-exclusive.[27] There is no discussion in RULPA's legislative history for the change from ULPA's non-exclusivity rule to silence, and the change was likely either inadvertent or constituted the drafters' recognition that the interests of limited partners take different forms, the pick-your-partner principle may apply in some cases and not in others, a general rule should not be created, and the question should be left to common law. Alternatively, the drafters might have concluded that RULPA's inclusion of a charging order remedy preempts the field, such that saying nothing made the charging order exclusive.

The Revised Uniform Limited Partnership Act (2001) ("Re-RULPA") also provides for a charging order remedy, but it departs from both ULPA (expressly non-exclusive) and RULPA (silence as to exclusivity) and adopts the RUPA rule that the charging order is the "*exclusive* remedy by which a judgment creditor of a partner or transferee may satisfy a judgment out of a judgment debtor's transferable interest."[28] Again, there is no legislative history discussing the reason for the change from either ULPA's non-exclusivity rule or RULPA's silence. The RULPA official reporter suggests that the Re-RULPA drafters followed RUPA's lead unless they found sufficient reason to depart from RUPA rules.[29] It is not clear whether the drafters actively considered the RUPA exclusivity rule and affirmatively decided it should apply to limited partnership interests, or whether the RUPA exclusivity rule was applied as a default rule without further consideration of the distinctions between general partnerships and limited partnerships.

C. Limited Liability Companies—Uniform Statutes vs. Non-Uniform Statutes

Limited liability company statutes were enacted by forty-nine states prior to the promulgation of the first Uniform Limited Liability Company Act ("ULLCA") in 1996.[30] Although a Revised Uniform Limited Liability Company Act ("Re-ULLCA") was promulgated in 2006,[31] neither uniform statute has made major inroads among the states.[32] Both ULLCA and Re-ULLCA provide that the charging

27. Revised Unif. Ltd. P'ship Act (amended 1985) § 703, 6B U.L.A. 313 (2008).

28. Revised Unif. Ltd. P'ship Act § 703(e), 6A U.L.A. 463 (2008) (emphasis added).

29. The official commentary to Re-RULPA notes that "the Limited Partnership [Act] incorporates many provisions from RUPA and some from the Uniform Limited Liability Company Act ('ULLCA')." Prefatory Note, 6A U.L.A. 326 (2008).

30. *See* Unif. Ltd. Liab. Co. Act, 6B U.L.A. 545–652 (2008); J.W. Callison & M.A. Sullivan, Limited Liability Companies: A State-by-State Guide to Law and Practice ch. 14 (2010). Hawaii adopted ULLCA effective April 1, 1997, and has amended it three times—in 2004, 2006, and 2009. *See* Callison & Sullivan, *supra*, § 14:21; *cf*. Haw. Rev. Stat. Ann. § 428-101 to -1302 (LexisNexis 2008 & Supp. 2010).

31. *See* Revised Unif. Ltd. Liab. Co. Act, 6B U.L.A. 407–543 (2008).

32. According to the National Conference of Commissioners on Uniform State Laws, Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont, and West Virginia have enacted ULLCA, and Idaho, Iowa, Nebraska, and Wyoming have enacted Re-ULLCA. *See A Few Facts About*

order is the exclusive remedy vis-à-vis a member's economic interest.[33] However, as with Re-RULPA, there is no legislative history concerning adoption of the exclusivity rule, and the author, who was present at Re-ULLCA drafting sessions, does not remember any discussion of why exclusivity is a proper result. The author suspects that exclusivity was somewhat slavishly adopted because both RUPA and Re-RULPA state that charging orders are exclusive.

However, most states have adopted LLC statutes that are not based on the uniform LLC acts. A review of the thirty-eight non-uniform statutes shows that seventeen non-uniform state LLC statutes contain some form of exclusivity provision,[34] and that twenty non-uniform statutes are silent as to whether the charging order is the exclusive remedy.[35] The Pennsylvania LLC statute appears to have no charging order provision at all.[36] Thus, *Olmstead* is particularly relevant in nineteen or twenty states in addition to Florida. As with limited partnerships, there is no clarity concerning why state legislatures adopted an exclusivity rule or failed to adopt an exclusivity rule. For those states with an exclusivity rule, the question is whether the rule is bad policy and should be changed.

the Uniform Limited Liability Company Act, NCCUSL, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ullca.asp (last visited Jan. 7, 2011); *A Few Facts About the Uniform Limited Liability Company Act (2006)*, NCCUSL, http://www.nccusl.org/Update/uniformact_factsheets/uniformacts-fs-ullca06.asp (last visited Jan. 7, 2011).

33. *See* ULLCA § 504(e), 6B U.L.A. 605 (2008); Re-ULLCA § 503(g), 6B U.L.A. 499 (2008).

34. Alaska Stat. Ann. § 10.50.380(c) (2010); Ariz. Rev. Stat. Ann. § 29-655(c) (1998); Cal. Corp. Code § 17302(e) (West 2006); Del. Code Ann. tit. 6, § 18-703(d) (2005); Kan. Stat. Ann. § 17-76, 113 (2007); Ky. Rev. Stat. Ann. § 275.260(1) (LexisNexis Supp. 2010); Minn. Stat. § 322B.32 (2008); Mont. Code Ann. § 35-8-705(5) (2009); Nev. Rev. Stat. Ann. § 86.401(2)(a) (LexisNexis 2010); N.J. Stat. Ann. § 42:2B-45 (West 2004); N.D. Cent. Code § 10-32-34(3) (2005); Okla. Stat. Ann. tit. 18, § 2034 (West 1999 & Supp. 2010); Tenn. Code Ann. § 48-218-105 (2002); Tex. Bus. Orgs. Code Ann. § 101.112(d) (Vernon 2009 & Supp. 2010); Utah Code Ann. § 48-2c-1103(5) (2010); Va. Code Ann. § 13.1-1041.1(D) (2006). Maine's statue, Me. Rev. Stat. Ann. tit. 31, § 686 (1996), is not exclusive, but was recently revised by the legislature—effective July 1, 2011—to read, in part, as follows:

> **Exclusive Remedy**. This section provides the exclusive remedy by which a judgment creditor of a member or transferee may satisfy a judgment out of the judgment debtor's transferable interest, and the judgment creditor may not foreclose upon the charging order or the judgment debtor's transferable interest. Court orders for actions or requests for accounts and inquiries that the judgment debtor might have made are not available under this chapter to the judgment creditor attempting to satisfy the judgment out of the judgment debtor's transferable interest and may not be ordered by a court.

2010 Me. Legis. Serv. ch. 629 (H.P. 1118) (West).

35. *See* Ark. Code Ann. § 4-32-703 (2001); Colo. Rev. Stat. Ann. § 7-80-703 (West 2006); Conn. Gen. Stat. Ann. § 34-171 (West 2005); Fla. Stat. Ann. § 608.433(4) (West 2007); Ga. Code Ann. § 14-11-504(b) (Supp. 2010); Ind. Code Ann. § 23-18-6-7 (West 2005); La. Rev. Stat. Ann. § 1332 (2010); Md. Code Ann. Corps. & Ass'ns § 4A-607(a)–(c) (LexisNexis 2007); Mass. Gen. Laws Ann. ch. 156C, § 41 (West 2005); Mich. Comp. Laws Ann. § 450.4507 (West 2002); Miss. Code Ann. § 79-29-703 (2001); Mo. Ann. Stat. § 347.119 (West 2001); N.H. Rev. Stat. Ann. § 304-C:47 (LexisNexis 2005); N.Y. Ltd. Liab. Co. Law § 607 (McKinney 2007); N.C. Gen. Stat. § 57C-5-03 (2009); Ohio Rev. Code Ann. § 1705.19 (West 2009); Or. Rev. Stat. Ann. § 63.259 (West 2009); R.I. Gen. Laws § 7-16-37 (1999); Wash. Rev. Code Ann. § 25-15-255 (West 2005); Wis. Stat. Ann. § 183.0705 (West 2002).

36. *See* 15 Pa. Cons. Stat. Ann. §§ 8901–8998 (West 1995 & Supp. 2010).

D. Summary

Across the states, there is no consistent statement of whether the charging order is the exclusive remedy of an LLC member's or a partner's judgment creditor. Charging orders are generally an exclusive statutory remedy in general partnerships, but may or may not be exclusive in limited partnerships and limited liability companies on a state-by-state basis.[37] Since the exclusivity question is important to creditors, to LLC members, and to LLCs generally, the exclusivity question calls for theoretical development and, perhaps, statutory rationalization.[38]

The exclusivity question is one part of a battle between two opposing policy considerations. On the one hand, there is a policy that considers creditors' interests and generally allows a judgment creditor to satisfy its claim by stepping into its debtor's shoes with respect to the debtor's assets.[39] The law generally allows this and, for example, the creditor of a shareholder in a close corporation can foreclose on the stock, and all interests related to that stock.[40] On the other hand, there is a policy favoring "private ordering" in unincorporated business organizations.[41] That policy respects the contractual nature of such organizations and protects the firm's and its members' autonomy by not forcing strangers into the firm's midst. As discussed herein, partnership law leans strongly toward the autonomy model,[42]

37. One issue, beyond the scope of this article, is whether LLC charging order provisions should be uniform among the states. The author believes they should be; otherwise, chaos would be created when states with personal jurisdiction over debtor members apply their creditor remedies with respect to member interests in LLCs formed in states where the charging order is the exclusive remedy. Further, exclusivity statutes are oddly written—they state that a charging order is the exclusive remedy against a member's economic interest, but are silent on remedies for other aspects of a member's interest in an LLC. The simple statement—"Charging orders are the exclusive method for judgment creditors to satisfy a judgment out of the member's LLC interest"—would suffice.

38. *See* J. William Callison, *Rationalizing Limited Liability and Veil Piercing*, 58 Bus. Law. 1063, 1067 (2003) ("An initial rationalization question is whether similar . . . rules should be established for all business entities regardless of whether they take a corporate, partnership or LLC form or, alternatively, whether there are inherent differences between these organizational forms such that each form should occupy an independent sphere with respect to [the question at hand]. A related question is whether a substantive basis remains for assigning different . . . rules to different firm structures irrespective of formation as corporations, partnerships, or limited liability companies. In this regard, function and structure should control over form.").

39. Bankruptcy courts have allowed the trustees of members to exercise full power with respect to the member's LLC interest in single member LLCs. *See, e.g.*, *In re* Albright, 291 B.R. 538 (Bankr. D. Colo. 2003). This indicates that the balance may have shifted to creditors in the bankruptcy context.

40. *See* Bishop, *supra* note 10, at 200 ("A separate creditor of a corporate shareholder may reduce an obligation to judgment, foreclose on the corporate stock and purchase the stock at the foreclosure sale. Absent enforceable contractual limitations, the purchasing creditor steps into the shoes of the former shareholder and owns all the former shareholder['s] rights represented by the shares.").

41. *See* Kleinberger, *supra* note 7, at 589–90 ("The 'pick-your-partner' principle has always been at the core of U.S. partnership law. . . . Partnership is a voluntary association, resting on a contract (express or implied) to co-own a business. . . . As a matter of basic definition, 'voluntary association' entails the power to pick one's associates, and partnership statutes have always protected that power.").

42. *See* J. William Callison & Allan W. Vestal, "*They've Created a Lamb with Mandibles of Death": Secrecy, Disclosure and Fiduciary Duties in Limited Liability Firms*, 76 Ind. L.J. 271, 293–99 (2001) (discussing autonomy model).

as demonstrated by the interest-transferability and charging order provisions. As with many "dueling policy" contests, this issue, highlighted in the context of a single member LLC and the absence of other participants relying upon autonomy, underlies decisions such as *Olmstead* and awaits final resolution.[43] It is likely that LLCs themselves, which, chameleon-like, take many colors, will encourage this discussion.[44]

II. The *Olmstead* Decision

In a 5-2 decision, the Florida Supreme Court held that a charging order is not an exclusive statutory remedy with respect to Florida LLCs.[45] However, it is not clear whether the court's decision that the charging order provision does not preclude a member's judgment creditor from executing on that member's entire bundle of membership rights is limited to single member LLCs. Since remedies other than charging orders may permit a member's judgment creditor to insert itself into the LLC's affairs, rather than passively awaiting distributions of profits, the scope of the court's holding is critical. It is relatively certain that the issues posed by *Olmstead* will be addressed by other courts, and one purpose of this article is to give those courts an appropriate theoretical basis for determining the exclusivity of LLC charging order remedies.

Olmstead's holding is succinct—"We conclude that the [Florida LLC Act's] statutory charging order does not preclude application of the creditor's remedy of execution on an interest in a single member [Florida] LLC."[46] To reach that conclusion, the court pursued two lines of analysis. First, the court "recognized" that the sole member in a single member LLC may unilaterally transfer his or her entire interest in the LLC, and not just his or her economic interest.[47] The court stated

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43. Since LLCs are flexible entities, the law should also be flexible on LLC issues; there should be no orthodox ideology expressed in LLC statutes. Absolute statements such as "charging orders are exclusive remedies" are likely incorrect. A better position is a pragmatic one based on the parties' relationships, not on the entity's formal title. *See* J. William Callison, "*The Law Does Not Perfectly Comprehend": The Inadequacy of the Gross Negligence Duty of Care Standard in Unincorporated Business Organizations*, 94 Ky. L.J. 451 (2005) (encouraging a pragmatic approach to duty of care standards in partnerships and LLCs).

44. The conflict is heightened by the fact that single member LLCs are inadequately theorized and that many LLC statutes allow single member LLCs to be used for non-business purposes. Single member LLCs are often used purely for asset protection purposes, with courts and creditors rebelling.

45. Olmstead v. FTC, 44 So. 3d 76, 78 (Fla. Sup. Ct. 2010).

46. *Id*. The court held that the execution remedy is permitted by Fla. Stat. § 56.0601, which states that various categories of real and personal property, including "stock in corporations," are subject to levy and sale. *Id*. at 80. It then jumped to the undeveloped and highly problematic statement that "[a]n LLC is a type of corporate entity, and an ownership interest in an LLC is personal property that is reasonably understood to fall within the scope of 'corporate stock.'" *Id*. Although the author does not have extensive knowledge of Florida remedies law, if execution and levy on an LLC ownership interest necessitates a finding that such interest is "stock in a corporation," *Olmstead* falls apart on its own logic since an LLC interest is not corporate stock, just as an LLC is not a corporation. Other courts that follow *Olmstead*'s lead in holding that the charging order remedy is not exclusive will need to develop rationale not based on *Olmstead* for concluding that a member's judgment creditor can reach the member's entire interest.

47. *Olmstead*, 44 So. 3d at 80.

that this voluntary transfer is accomplished through a "simple assignment" of the sole member's interest to the transferee.[48] The court distinguished single member LLCs from multiple member LLCs by referring to a provision in the Florida LLC Act, in common with all or almost all other state LLC statutes, to the effect that an assignee of a member's economic interest becomes a substitute member only with the consent of other members.[49] This, simply put, constitutes application of the pick-your-partner principle to LLCs. Since the pick-your-partner principle, according to the court, is not applicable to single member LLCs that, by definition, do not have "other members," the court concluded that the underlying theory of charging order exclusivity also is not applicable to single member LLCs.[50]

As discussed below, the court's conception of both single member LLCs and multiple member LLCs is both highly stylized and overly simplistic, and fails to acknowledge that there can be situations where participants in a single member LLC can limit assignability of member rights, where an ostensible multiple member LLC is effectively a single member LLC, and where a multiple member LLC is not governed by pick-your-partner principles because of operating agreement provisions.[51] Further, the court fails to consider the foundations of pick-your-partner principles in general partnership law and to consider whether and the extent to which they fit the LLC context.

Second, the *Olmstead* court compared the charging order provisions in Florida's general partnership law and Florida's limited partnership law, each of which is based on a correlative uniform act, with the Florida LLC Act, which is not.[52] The Florida general and limited partnership statutes expressly state that a charging order is an exclusive remedy with respect to a partnership interest, while the Florida LLC statute contains no exclusivity language.[53] The court concluded, as a matter of statutory interpretation, that the member's exclusivity argument was based on an "unwarranted interpretive inference which transforms a remedy that is nonexclusive on its face into an exclusive remedy."[54] From there, the court held that recognition of the full scope of a judgment creditor's rights with respect to a judgment debtor's freely alienable membership interest in a single member LLC is not inconsistent with the plain meaning of the statute.[55]

Disregarding the fact that the majority's holding could be limited to "freely alienable" interests in single member LLCs, the dissent strongly argues that the majority's reasoning applies to multiple member LLCs and "render[s] the assets of all LLCs vulnerable."[56] In the dissenters' view, the charging order provisions

48. *Id.*
49. *Id.* at 81.
50. *Id.*
51. The dissenting opinion also is highly stylized and overly simplistic, and does not much assist in understanding the holding.
52. *Olmstead*, 44 So. 3d at 82. This may show the danger of intra-state uniform act adoption in some, but not all, cases.
53. *Id.*
54. *Id.* at 83.
55. *Id.*
56. *Id.* at 84 (Lewis, J., dissenting).

of the Florida LLC Act implicitly displaced the availability of execution remedies by providing a remedy preventing judgment creditors from seizing ownership interests and liquidating the LLC's separate assets.[57] The dissenters state that "[i]n stripping the statutory protections designed to protect an LLC as an entity distinct from its owners, the majority obliterates the distinction between economic and governance rights by allowing a judgment creditor to seize both from the member and to liquidate the separate assets of the entity."[58] As further discussed below, the dissenters misapprehend the significance of a creditor stepping into a debtor member's shoes with respect to non-economic rights. Both *Olmstead*'s majority opinion and the dissent demonstrate that some courts have a considerable distance to travel before they understand LLC law.

III. Analyzing *Olmstead* and the Exclusivity Question

The *Olmstead* court reached the right conclusion on the facts before it (i.e., a single member LLC with freely alienable membership interests), and possibly for the right reasons. However, in failing to articulate an underlying theory of the pick-your-partner principle and to apply it to LLCs in a broader context, the court left open numerous questions concerning both the breadth of its holding and its application to Florida LLCs generally.[59]

A better reasoned holding would have had the following elements:

(a) Although the Florida LLC Act does not mandate a conclusion that the charging order remedy is exclusive, it also does not require the opposite conclusion that other remedies are available to a member's judgment creditors in all cases.

(b) Since the statute does not specifically mandate either exclusivity or non-exclusivity, Florida courts must determine in each particular case whether the remedies of a member's judgment creditors are or are not limited to the charging order. To do this, courts must consider the application of pick-your-partner principles to the LLC in question.

(c) Since the Florida LLC Act includes pick-your-partner principles in its default rules,[60] there should be a rebuttable presumption that charging orders are exclusive.

(d) With respect to single member LLCs, in most, but perhaps not all, cases, pick-your-partner principles will not be applicable and charging orders should not be the exclusive remedy. However, there may be other cases

57. *Id.*

58. *Id.* at 86.

59. The dissent's emphatic response demonstrates that these questions might have been minimized by a well articulated majority opinion.

60. *See* Fla. Stat. Ann. § 608.432(1)(a) (West 2007) ("The assignee of a member's interest shall have no right to participate in management of the business and affairs of a limited liability company except as provided in the articles or operating agreement and upon . . . [t]he approval of all of the members . . . other than the member assigning the . . . interest.").

in which the facts will support application of pick-your-partner principles, and the charging order remedy should be exclusive.

(e) Multiple member LLCs, while generally incorporating pick-your-partner principles as a default rule, may adopt rules that are inconsistent with those principles in their operating agreements. Decisions concerning the exclusivity of the charging order remedy depend upon application of pick-your-partner principles to the particular LLC, and if the members' operating agreement allows complete transferability of interests, the charging order should not be the exclusive remedy.

(f) If a member's judgment creditor forecloses on the member's entire interest, the judgment creditor only has the powers and rights the debtor member had vis-à-vis the LLC and the other members. The operating agreement and the statute define those powers and rights.

These points are discussed in the following analysis.

1. *The pick-your-partner principle is not embedded in LLC law, and therefore charging orders should not be the exclusive statutory remedy*. The pick-your-partner principle is appropriate for traditional, UPA-based general partnerships for numerous reasons. First, the UPA was promulgated against a common law background in which courts conceptualized partner property rights as joint ownership of partnership assets whereby a partner's creditors were entitled to execute against specific partnership assets.[61] The UPA's drafters recognized the resulting nuisance to the partnership and the other partners and the complexity of equitable solutions to this problem, and the charging order was a creative solution. Second, under the UPA, each partner is an agent of the partnership for the purpose of its business and can bind the partnership by his or her acts within the scope of the partnership's business.[62] Third, under the UPA, all partners are jointly, or jointly and severally, liable for all partnership debts and obligations.[63] Fourth, under the UPA, all partners have equal rights in management and conduct of the partnership's business.[64] Fifth, partners in UPA partnerships have full access to partnership books and records and partners are obligated to render full information of all things affecting the partnership on another partner's demand.[65] Sixth, each partner in a UPA partnership can cause partnership dissolution by his or her express will,[66]

61. *See* J. Dennis Hynes, *The Charging Order: Conflicts Between Partners and Creditors*, 25 Pac. L.J. 1, 3 (1993) ("At common law, the enforcement of judgments by personal creditors of a partner against the assets the debtor had in a partnership presented serious difficulties for the other partners. Execution of judgments at common law reached only the tangible assets. Courts at common law conceptualized the property rights of partners as joint ownership of the partnership assets. Thus, creditors of partners were entitled to execute against specific assets owned by the partnership. This disrupted partnership business and operated to the disadvantage of the nondebtor partners.").

62. UPA § 9(1), 6 U.L.A. (pt. I) 553 (2001).

63. *Id.* § 15, 6 U.L.A. (pt. I) 613.

64. *Id.* § 18(e), 6 U.L.A. (pt. II) 101.

65. *Id.* § 19, 6 U.L.A. (pt. II) 184 ("[E]very partner shall at all times have access to and may inspect and copy any of [the partnership books]."); *id.* § 20, 6 U.L.A. (pt. II) 188 ("Partners shall render on demand true and full information of all things affecting the partnership to any partner . . . .").

66. *Id.* § 31(1)(b)–(c), (2), 6 U.L.A. (pt. II) 370.

although the effect of dissolution depends on whether the partner's dissociation is rightful or wrongful. When rightful, each partner may force liquidation of the partnership.[67] When wrongful, non-dissociating partners may force partnership liquidation,[68] or they can continue the partnership's business and pay the dissociating partner the value of his or her interest, reduced by damages.[69] Finally, in UPA partnerships, partners owe fiduciary duties to the partnership and, at least to some extent, their co-partners.[70] Given the power of individual partners, and their ability to create liability for vulnerable co-partners, the pick-your-partner principle makes entire sense.

As the dominance of the UPA has faded in favor of RUPA, arguably so have the foundations of the pick-your-partner principle in general partnership law. Under RUPA, "[a] partnership is an entity distinct from its partners," and ancient common law rules concerning partner rights to partnership property have disappeared.[71] Partners continue to have apparent agency authority to bind the partnership,[72] but partnerships can file statements of authority limiting the authority of some or all partners to enter transactions on the partnership's behalf.[73] RUPA continues the tradition of partner individual liability for partnership debts and obligations,[74] but also allows limited liability partnerships ("LLPs") in which partners lack personal liability.[75] Under RUPA, partners have equal rights in the management and conduct of the partnership's business,[76] but RUPA allows the partnership agreement to vary this rule such that partners can establish management authority as they see fit.[77] RUPA retains partner information rights,[78] and specifies partner fiduciary duties that run to the partnership and to co-partners.[79] Finally, in at-will and term partnerships, partner dissociation requires partnership liquidation,[80] but other partner dissociations permit partnership continuation without dissolution and liquidation.[81]

67. *See id.* § 38(1), 6 U.L.A. (pt. II) 487 ("When dissolution is caused in any way, except in contravention of the partnership agreement, each partner . . . may have the partnership property applied to discharge its liabilities, and the surplus applied to pay in cash the net amount owing to the respective partners.").

68. *Id.* § 38(2)(a), 6 U.L.A. (pt. II) 487.

69. *Id.* § 38(2)(b).

70. *See id.* § 21, 6 U.L.A. (pt. II) 194 ("Every partner must account to the partnership for any benefit, and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct, or liquidation of the partnership or from any use by him of its property.").

71. *See* RUPA §§ 201(a), 203, 6 U.L.A. (pt. I) 91, 96 (2001).

72. *Id.* § 301(1), 6 U.L.A. (pt. I) 101.

73. *Id.* § 303(a)(2), 6 U.L.A. (pt. I) 107–08.

74. *Id.* § 306(a), 6 U.L.A. (pt. I) 117.

75. *Id.* § 306(c).

76. *Id.* § 401(f), 6 U.L.A. (pt. I) 133.

77. *Id.* § 103(a), 6 U.L.A. (pt. I) 73.

78. *See id.* § 403, 6 U.L.A. (pt. I) 140.

79. *Id.* § 404, 6 U.L.A. (pt. I) 143.

80. *Id.* § 801(1), (2)(i)–(ii), 6 U.L.A. (pt. I) 189.

81. *Id.* § 701, 6 U.L.A. (pt. I) 175–76.

As noted above, the default rule under RUPA is partner consent for the admission of new partners,[82] and RUPA provides that charging orders are the exclusive means by which a partner's creditors can reach the partner's transferable interests in the partnership, namely the distributions when and as made by the partnership.[83] Although the foundation for pick-your-partner principles has weakened in comparison to the UPA, RUPA evidences a policy decision that pick-your-partner principles should remain dominant in general partnership law. Under RUPA's default rules in which each partner has agency authority and partnerships are not LLPs, this is by and large an appropriate conclusion. It is supported by the fact that, at least since the advent of LLCs, general partnerships frequently are inadvertent and undocumented, and in such cases the default rules of joint and several liability, apparent agency authority, and equal management participation apply.

LLCs are different in many respects from general partnerships. First, LLC members and managers are not personally liable for entity debts and obligations.[84] Second, LLCs can be, and often are, manager-managed. In those cases, members do not participate in LLC management decisions in their capacities as members[85] and they do not have apparent agency authority to bind the LLC.[86] Third, members of manager-managed LLCs generally do not have fiduciary obligations to the LLC or the other members.[87] Fourth, in manager-managed LLCs, member information rights are more limited than those of general partners in general partnerships.[88] Fifth, member dissociation generally does not cause an LLC's dissolution.[89] Sixth, LLCs are formed by a filing with a state official and are not inadvertently formed.[90] The fact that LLCs are intentional associations, combined with the fact that they are generally recognized as contractual entities in which members can order their own affairs through an operating agreement, means that statutory default rules frequently are inapplicable.[91] For example, LLC statutes generally provide that members can assign their economic interests freely, but that the assignee does not participate in management, have access to information concerning the LLC's activities, or have other non-economic member rights until admitted to the LLC as a member by the consent of other members.[92] An assignee who is not admitted to membership is therefore dependent on the other members to conduct the LLC's affairs, at least to the extent the other members have that power. However, since the "check-the-box" rules eliminated the need for lawyers to consider whether the interests of an LLC should be freely transferable to enable the LLC to be taxed as

82. *Id.* § 401(i), 6 U.L.A. (pt. I) 133.
83. *Id.* § 504(e), 6 U.L.A. (pt. I) 160.
84. Re-ULLCA § 304(a)(1), 6B U.L.A. 475 (2008).
85. *Id.* § 407(c)(1), 6B U.L.A. 484.
86. *Id.* § 301(a), 6B U.L.A. 469.
87. *Id.* § 409(g)(1), (3) & (5), 6B U.L.A. 489.
88. *See id.* § 410, 6B U.L.A. 492–94.
89. *Id.* § 701, 6B U.L.A. 506.
90. *Id.* § 201, 6B U.L.A. 456–57.
91. *See id.* § 110, 6B U.L.A. 442–44.
92. *See*, *e.g.*, *id.* § 502, 6B U.L.A. 496–97.

a partnership,[93] many LLC operating agreements allow complete substitution of members without consent,[94] thereby negating the "pick-your-partner" principle. Because the foundational "pick-your-partner" principle is not embedded in LLC law, charging order exclusivity, itself arising from embedded principles of partnership law, should not apply to LLCs.

Given the diminished basis for applying the pick-your-partner principle to LLCs, it is entirely appropriate that many state LLC statutes do not provide a charging order as the exclusive remedy for judgment creditors. States that have opted for exclusivity should reconsider that decision. The simple fact is that, in at least some LLCs, admission of judgment creditors to full LLC membership in place of the judgment debtor will not damage the expectations of the LLC or its other members.

2. *On the other hand, it may be appropriate for member creditors to be limited to a charging order remedy in certain cases and, therefore, it is incorrect to conclude that charging orders are non-exclusive in all cases as a matter of law*. As noted, the *Olmstead* court held that a charging order is not the exclusive creditor remedy in single member LLCs with freely alienable membership interests. While this is a reasonable conclusion on the *Olmstead* facts, it is inappropriate to stretch *Olmstead* to the conclusion that charging orders are *never* the exclusive creditor remedy in LLCs. Although the dissent's hyperbole obscures this, *Olmstead* does not mandate such a strong conclusion. The *Olmstead* majority did not explicitly rule that because the Florida LLC Act does not provide exclusivity, the charging order remedy is non-exclusive and other remedies, such as execution, can be obtained in every case. Instead, the court held that charging orders are not a statutorily exclusive remedy, and leaves it to trial courts to determine whether a charging order is exclusive in each particular case. The dissent correctly notes that the majority "fails to directly address the critical issue of whether the charging order provision applies uniformly to all limited liability companies regardless of membership composition."[95] However, any such direction would have been dictum, and the dissent reads the majority opinion too strongly. It is incorrect to conclude that "the same theories apply to multimember LLCs and render the assets of all LLCs vulnerable," creating "a disaster" for multimember LLCs.[96]

3. *The correct approach is a pragmatic approach that establishes a rebuttable presumption of exclusivity but then considers the circumstances of a particular LLC*. Charging order exclusivity should be presumed, but the presumption should be rebuttable by a showing that membership interests in an LLC are freely transferable pursuant to the members' operating agreement or because of the nature of

93. *See* Treas. Reg. § 301.7701-3 (1997) (entity classification rules). For a discussion of the history of unincorporated business entity tax classification, see J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. Corp. L. 951, 957–60 (2001).

94. This is permissible under Re-ULLCA § 110, 6B U.L.A. 442–44 (2008).

95. 44 So. 3d 76, 84 (Fla. Sup. Ct. 2010) (Lewis, J., dissenting).

96. *Id*. However, if the dissent reads the majority opinion correctly, such that the majority opinion states "since not exclusive, therefore nonexclusive," it is correct in its conclusions.

the particular LLC. Rebuttable presumptions are intended to promote results that conform the probable connection of a basic fact (i.e., pick-your-partner principles generally apply to LLCs) with a presumed fact (i.e., charging orders are an exclusive remedy).[97] Under this analysis, there should be an exclusivity presumption when it is probable, because of the default rules contained in LLC statutes, that pick-your-partner principles apply to LLCs.[98] Similarly, presumptions are (or should be) employed when they serve to minimize the costs of deciding cases.[99] Under this analysis, exclusivity should be presumed if such a presumption would result in fewer judicial errors or increased administrative savings than would be the case if judges were required to decide exclusivity questions without a presumption, as is likely the case here. In addition, judges and legislators create presumptions in order to tilt case results in favor of a desired policy.[100] Thus, although a presumption that charging orders are an exclusive remedy should be based on probability or cost-benefit analyses, the desirability of the charging order as an exclusive remedy also favors a presumption of exclusivity.[101]

Creating a rebuttable presumption that the charging order is the exclusive remedy of LLC members' judgment creditors makes sense. All state LLC statutes provide, as a default rule, that members can freely assign their economic interests, but that assignment of non-economic member rights requires the consent of other members.[102] Thus, pick-you-partner principles apply to LLCs as a basic fact,[103] and the presumed fact of the charging order as an exclusive remedy of the members' judgment creditors follows. An exclusivity presumption would minimize both judicial costs in deciding cases, and member, creditor, and LLC costs in understanding the applicable rules, while preserving flexibility for those LLCs that have chosen to depart from the default rule. Finally, an exclusivity presumption

97. "A standard definition of presumptions is '[W]hen a designated basic fact or aggregate of facts exists, existence of another fact or aggregate of facts, called the presumed fact or facts, must be assumed in the absence of adequate rebuttal.'" Neil S. Hecht & William M. Pinzler, *Rebutting Presumptions: Order Out of Chaos*, 58 B.U. L. Rev. 527, 528 (1978) (quoting John MacArthur Maguire, Evidence, Common Sense & Common Law 183 (1949)); *see also* Roy R. Ray, *Presumptions and the Uniform Rules of Evidence*, 33 Tex. L. Rev. 588, 590 (1955) ("A large proportion of presumptions are based wholly or partly on probability. In certain recurring fact situations common experience has shown that when fact A is proved the existence of fact B is so probable that the courts may assume its truth.").

98. *See, e.g.*, Alfred L. Gausewitz, *Presumptions in a One-Rule World*, 5 Vand. L. Rev. 324, 330 (1952) ("Since a presumption shifts and sometimes modifies the burdens of proof, it would seem obvious that the reasons for fixing the burdens in the first place would have to be considered in deciding whether and to what extent to change them. It would further seem that the decision to change those burdens would have to be based upon considerations similar to those which fixed them initially.").

99. *See* David A. Strauss, *The Ubiquity of Prophylactic Rules*, 55 U. Chi. L. Rev. 190, 193 (1988) (presumptions are created "to minimize the sum of error costs and administrative costs" of deciding cases).

100. *See* Gausewitz, *supra* note 98, at 329 (listing various policies served by presumptions).

101. Resolution of this question ultimately depends on whether the policy that creditors should have strong remedies against debtor assets is dominant, or whether LLC and member autonomy is a dominant policy. I do not venture into these policy waters, but note that, in my view, creditor interests were underrepresented when the uniform unincorporated business organization acts were drafted. Therefore, the policy question may be an open one.

102. The consent requirement can be modified or eliminated by agreement.

103. It is not a purpose of this article to discuss whether they should.

would constitute a general continuation of existing charging order law and, for the reasons noted by the dissent in *Olmstead*, would tilt case results in favor of the desired policy of member control of their LLCs.

The exclusivity presumption should be rebuttable by a creditor showing that the LLC's operating agreement or ownership structure renders the member's interest freely transferable without the consent of other members or third parties. For example, when the LLC's operating agreement provides that an assignment of a member's economic interest permits the assignee to become a full substitute member without further consent from the other members, the exclusivity presumption would be rebutted. In such case, since the members have, by private ordering, agreed that they cannot control who the other members are, the LLC statute should not presume that they can control who the members are when creditors are involved. Further, in the case of single member LLCs, a creditor could rebut the exclusivity presumption by showing, as in *Olmstead*, that there is no interested third party whose consent is required for substitution. Such a rebuttal would likely be commonplace in most single member LLC cases, but there may be situations in which the LLC operating agreement gives an interested third party, such as a non-member manager with strong management powers and a long-term financial interest in the LLC, the discretion to admit assignees as full members. In other instances, the single member LLC may have business or contractual relationships with third parties that would inequitably suffer if the judgment creditor were substituted for the single member. In such cases, the exclusivity presumption could stand. The rebuttable presumption would also be effective in the case of multiple member LLCs dominated by the debtor member. For example, a family-owned LLC might have a primary member and a lesser member. In addition, in some states LLCs can be formed with non-economic members.[104] If a creditor can demonstrate that the debtor member so dominates the decision making for the LLC that, in effect, there is no third-party member whose consent is needed for assignee substitution, then the exclusivity presumption might be rebutted with respect to that member's creditors.

4. *Limitations of Full Substitution*. Even in situations where charging orders are non-exclusive, it does not follow that a particular judgment creditor will be able to avail itself of other remedies. First, before foreclosing on an LLC interest, a judgment creditor must find a state law rule permitting foreclosure of the interest. Second, the creditor may be required to submit to a court's equitable powers in obtaining the foreclosure order and the court could determine that foreclosure of the member's entire LLC interest is not permitted. A conclusion that a member's judgment creditor is not *prevented* from further remedies by the state LLC act does

104. *See, e.g.*, Colo. Rev. Stat. § 7-80-501 (2006) ("A person may be admitted to a limited liability company as a member of the [LLC] and may receive a membership interest . . . without making a contribution or being obligated to make a contribution . . . . Unless otherwise provided in the operating agreement, a person may be admitted as the sole member of a limited liability company without making a contribution or being obligated to make a contribution . . . or without acquiring a membership interest in the . . . company.").

not of itself *permit* such remedies or eliminate equitable considerations. Rather, the remedies universe is merely opened to possibilities beyond the very limited charging order remedy.

Even when a member's judgment creditor fully steps into the member's shoes, it does not follow that the LLC's assets are at risk or that they can be obtained by the judgment creditor. For example, assuming a manager-managed LLC with five equal members, a foreclosing judgment creditor would obtain only the rights of a 20 percent member, as established by the operating agreement and applicable state law. If the manager (or alternatively a majority of the members) is empowered to make distribution decisions, the member's judgment creditor cannot force distributions. If the manager, with the consent of all or a majority of the members, makes decisions with respect to sales of all or substantially all of the LLC's assets, the judgment creditor cannot force the LLC's liquidation. If a majority of the members appoint (and remove) the LLC's manager, the judgment creditor cannot force a regime change. Since the manager generally has both the decision-making power and agency authority to act on the LLC's behalf,[105] the judgment creditor cannot act. While it may be the case that the judgment creditor would step into the debtor member's shoes such that it would be owed fiduciary duties, could derivatively enforce the fiduciary duties owed to the LLC, and be entitled to inspect any LLC books and records,[106] even those rights may be circumscribed by the LLC's operating agreement. Further, when the foreclosing creditor becomes a substitute member it likely would take on fiduciary duties to the LLC and the other members.[107] Those fiduciary duties, which are heightened in the case of member-managed LLCs in which the judgment creditor might have additional power, could even cause the judgment creditor to think hard about foreclosing on the debtor member's entire interest.

5. *Summary*. If charging order exclusivity does not exist in particular LLCs under the rebuttable presumption rule proposed above, it is because the members do not care about untoward exercises of power by third parties, often because the LLC has strong central management with little member power. There simply is no great danger to the LLC or the other members and participants resulting from a stranger's admission into full management participation in the LLC. For the same reason, insertion of a member's judgment creditor as a member poses no great danger to either the LLC itself or the other members. In situations where the right

105. *See* Callison & Sullivan, *supra* note 30, §§ 8:59, 58:6 (discussing manager management and authority).

106. Re-ULLCA § 409(a), 6B U.L.A. 489 (2008) ("A member of a member-managed [LLC] owes to the company and . . . the other members the fiduciary duties of loyalty and care."); *id*. § 902, 6B U.L.A. 523 ("A member may maintain a derivative action to enforce a right of a limited liability company . . . ."); *id*. § 410(a)(1), 6B U.L.A. 492–493 ("On reasonable notice, a member may inspect and copy during regular business hours, at a reasonable location specified by the company, any record maintained by the company regarding the company's activities, financial condition, and other circumstances, to the extent the information is material to the member's rights and duties under the operating agreement or this [act].").

107. *See id*. § 409(a), 6B U.L.A. 489.

to management participation is personal to non-fungible members, the members' operating agreement will require member consent to admission of new members, and the exclusivity presumption will hold.

IV. Conclusion: Statutory Drafting and Statutory Uniformity

Assuming that a rebuttable presumption approach to charging order exclusivity makes sense, it can be attained in at least two ways. First, one or more authoritative judicial decisions can adopt the approach and those states that presently have exclusivity language in their LLC charging order statutes can eliminate the language in favor of the developing common law. However, given the relatively slow pace of common law development, combined with the fact that a litigable question would arise only in the minority of states that do not now use exclusivity language, this process may not occur or it would occur too slowly.

Second, states, perhaps prodded by the uniform statutes' drafters, could hasten the pace by amending their LLC statutes to provide that:

> Charging orders are the exclusive remedy by which a member's judgment creditors can reach the member's interests in the company; provided, however, that if the judgment creditor can demonstrate that all or any part of the member's interest in the company can be assigned by the member to a third party without the other members' consent, then the charging order shall not be an exclusive remedy with respect to such freely assignable interest.[108]

Such a statutory approach is both necessary and desirable, and should be uniform among the states. The National Conference of Commissioners on Uniform State Laws, presently involved in an entity-rationalization drafting process, should take the lead, with legal scholars and others interested in the thoughtful development of LLC law advocating this result in the various state legislatures.[109]

Charging order exclusivity presents a very real problem that perplexed the Florida Supreme Court in *Olmstead* and will likely similarly perplex other courts in months and years to come. It is a problem that comes from what might be viewed as a statutory attempt to override creditor rights principles with the party autonomy principles that have found their home in LLC statutes governing LLCs that may have themselves abandoned party autonomy. A uniform rule of charging

108. The nomenclature is derived from Re-ULLCA and would need to be modified to fit the state statute.

109. NCCUSL already knows how to accomplish what this article suggests. The Uniform Statutory Trust Entity Act ("USTA"), a NCCUSL product, provides generally that a beneficial interest is freely transferable and that, to the extent there is a judgment against the beneficial owner, the judgment creditor can succeed to the beneficial owner's entire interest in the trust. However, "[i]f a beneficial interest is not freely transferable . . . so that the transferee has all rights of the transferor, a judgment creditor of a beneficial owner may satisfy the judgment . . . only as provided in this section [i.e., by a charging order]." Unif. Statutory Trust Act § 606(a), 6B U.L.A. 84 (Supp. 2010). For a general overview of the USTA, see Thomas E. Rutledge & Ellisa Opstbaum Habbart, *The Uniform Statutory Trust Entity Act: A Review*, 65 Bus. Law. 1055 (2010).

order exclusivity, or an opposite rule of non-exclusivity, does not fit the current LLC environment. Mandatory rules should be abandoned in favor of a more pragmatic approach that recognizes the statutory reality of LLCs by creating a presumption of charging order exclusivity, while recognizing the practical realities of LLCs by making the presumption rebuttable in situations where the members and other participants abandon pick-your-partner principles. This flexible rule would create a relatively easy balance between the extremes that could be enforced by the courts.

Keeping "Fiduciary Outs" Out of Shareholder-Proposed Bylaws: An Analysis of *CA, Inc. v. AFSCME*

*By Sabrina Ursaner**

Editor's Note

Each year, the Section of Business Law sponsors the Mendes Hershman Student Writing Contest to encourage and reward law student writings on business law subjects of general and current interest. Essays submitted for consideration must be the work of the submitting student without substantial editorial input from others. The papers are judged on research and analysis, choice of topic, writing style, originality, and contribution to the literature available on the topic. Depending on the topic, whether the paper has been previously published, and other factors, the winning essay is considered for publication in The Business Lawyer.

The winning essay for the 2009–2010 contest was submitted by Sabrina Ursaner. Ms. Ursaner's paper has previously been published in Volume 6 of the NYU Journal of Law & Business, *so it is not being republished here. Ms. Ursaner was awarded the Mendes Hershman Student Writing Contest Prize at the Section's luncheon at the Spring Meeting in March 2010.*

An abstract of Ms. Ursaner's essay is set forth below.

The question of whether shareholders can amend bylaws to give themselves increased access to the ballot or greater opportunities to nominate board members falls in the middle of an ongoing debate over how control of the corporation should be allocated between shareholders and directors. The issue also highlights the potential for conflict between two seemingly clear statutory rights: the shareholders' right to amend bylaws under Delaware General Corporation Law ("DGCL") § 109, and the board's right to manage the corporation under DGCL § 141(a). This Note examines the *CA, Inc. v. AFSCME Employees Pension Plan* opinion of the Delaware Supreme Court in order to (1) look at the extent to which section 141(a) limits section 109 in this context, and (2) discuss why fiduciary outs should not be required in shareholder-proposed bylaws, particularly in light of the 2009 amendments to the DGCL explicitly authorizing Delaware corporations to adopt proxy access and proxy expense reimbursement bylaws.

* Law Clerk, Chancellor William B. Chandler III, Delaware Court of Chancery, 2010–2011; J.D. 2010, New York University School of Law. The author would like to thank Jennifer Arlen, Bill Allen, Stephen Choi, Jeffrey Gorris, Marcel Kahan, Ryan A. McLeod, Theodore Mirvis, and Vice Chancellor Leo E. Strine, Jr. for their guidance and extremely helpful comments on earlier drafts of this paper.

The power struggle between shareholders and directors is nothing new in corporate law, and academics have weighed in heavily on both sides of the debate. Leading the pack in support of shareholder empowerment is Lucian Bebchuk, who argues that shareholders should have greater access to the ballot and an increased ability to control the balance of power between themselves and management. On the directors' side, Martin Lipton has long advocated a pro-management stance, Stephen Bainbridge has advanced his "director primacy" theory, and several academics and practitioners alike have pushed back against Professor Bebchuk's proposals. The present focus of the debate is on shareholder efforts to gain more control over the election process, and this power struggle is currently being played out in the bylaw context.

So which side is right? Who *should* be making important corporate decisions that will affect how a company is run? Should shareholders, as owners of the corporation, have the power to adopt bylaws that could potentially impinge upon managerial power, or should directors have unfettered discretion to run the corporation as they see fit so long as they comply with their fiduciary duties and act in what they believe to be the best interests of the company?

In *CA, Inc. v. AFSCME Employees Pension Plan*,[1] the Delaware Supreme Court made its view known on an important battleground in the debate over corporate control—shareholder-adopted bylaws regulating the process for electing directors. The Delaware Supreme Court held that bylaws mandating reimbursement of expenses in contested election contests are a proper subject for shareholder action, but not without a fiduciary out. The Delaware legislature has since responded by amending the DGCL, essentially codifying the first part of the *AFSCME* opinion and explicitly authorizing bylaws relating to proxy access and reimbursement of election expenses. The DGCL amendments, however, make no mention of fiduciary outs. This leaves open two questions. The first is what *AFSCME* suggests about the permissible scope of future shareholder-adopted bylaws. The second is how courts should handle fiduciary outs in the bylaw context in the future.

This Note attempts to answer both of those questions. First, it examines the fine line between what has historically been considered a proper subject for corporate bylaws and what has not. It then attempts to determine where the limits on the scope of shareholder-proposed bylaws may lie in the future. Moreover, this Note addresses how such bylaws should be written where there is the possibility of future conflict between the board's right to manage under section 141(a) of the DGCL and the mandate of a proposed bylaw. Specifically, in light of the Delaware Supreme Court's decision in *CA, Inc. v. AFSCME Employees Pension Plan*, which seems to suggest that a "fiduciary out" clause can cure the defects that might otherwise plague a shareholder-proposed bylaw that has the potential to interfere with a board's right to manage the company, I argue that a fiduciary out is not the answer, and that indeed, it would be dangerous to introduce the concept of fidu-

1. 953 A.2d 227 (Del. 2008).

ciary outs into the bylaw context. This Note discusses the implications of expanding the use of fiduciary outs in such a manner.

The Note is organized as follows. Part I provides an overview of the *AFSCME* opinion and the events leading up to the decision. Part II analyzes the Delaware Supreme Court's reasoning in coming to its decision that reimbursement of expenses is a proper subject for shareholder-proposed bylaws. This Part also discusses the 2009 amendments to the DGCL, looking at how these amendments potentially affect the interpretation and impact of the court's decision on future shareholder proposals. Part III analyzes the court's reasoning as to whether the particular bylaw in question in *AFSCME* would be legal under Delaware law and challenges the validity of the court's conclusions—specifically, the court's suggestion of including a fiduciary out in the bylaw in order for it to be deemed valid. This Part briefly traces the history and purpose of fiduciary outs, focusing on the situations where they have been used and required in the past. Part III then goes on to suggest that using fiduciary outs in the shareholder bylaw context is inconsistent with the history and purpose of fiduciary out exceptions. Instead, this Note suggests that fiduciary outs were designed to protect shareholders in situations where a board could take action that would usurp the shareholders' choice—a danger that is not present in the shareholder-adopted bylaw context. Finally, Part IV considers the implications of the *AFSCME* decision and suggests where courts (and shareholders in drafting their bylaw proposals) should go from here.

The complete Note was previously published at 6 N.Y.U. J.L. & Bus. 479 (2010).

Changes in the Model Business Corporation Act—Amendments to Permit Limitations on Separate Group Voting Rights on Certain Mergers, to Delink Voting and Appraisal Rights, and to Make Related Changes

*By the Committee on Corporate Laws, ABA Section of Business Law**

The Committee on Corporate Laws of the ABA Section of Business Law from time to time makes changes in the Model Business Corporation Act.

By publication after second reading in the August 2010 issue[1] of *The Business Lawyer*, the Committee proposed amendments to the Model Act to permit limitations on separate group voting rights on certain mergers, to delink voting and appraisal rights, and to make related changes.

At its meeting on December 11, 2010, the Committee approved the amendments upon third and final reading without change.

* A. Gilchrist Sparks III, Chair.

1. Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Proposed Amendments to Permit Limitations on Separate Group Voting Rights on Certain Mergers, to Delink Voting and Appraisal Rights, and to Make Related Changes*, 65 Bus. Law. 1121 (2010).

Changes in the Model Business Corporation Act—Amendment to Section 8.58 Relating to Indemnification

*By the Committee on Corporate Laws, ABA Section of Business Law**

The Committee on Corporate Laws of the ABA Section of Business Law from time to time makes changes in the Model Business Corporation Act.

By publication after second reading in the August 2010 issue[1] of *The Business Lawyer*, the Committee proposed an amendment to section 8.58 of the Model Act relating to indemnification.

At its meeting on December 11, 2010, the Committee approved the amendment upon third and final reading without change.

* A. Gilchrist Sparks III, Chair.

1. Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Proposed Amendment to Section 8.58*, 65 Bus. Law. 1149 (2010).

Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions

*By the Annual Survey Working Group of the M&A Jurisprudence Subcommittee, Mergers and Acquisitions Committee, ABA Section of Business Law**

The primary charge of the Annual Survey Task Force is to monitor and summarize annually significant judicial decisions in the area of mergers and acquisitions ("M&A") we believe to be of greatest interest to a wide range of M&A practitioners.[1]

Survey Cases

The decisions summarized in this year's *Annual Survey* are

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* The Working Group is chaired by Michael O'Bryan, of Morrison & Foerster LLP in San Francisco, California. The M&A Jurisprudence Subcommittee is chaired by Jon T. Hirschoff, of Finn Dixon & Herling LLP in Stamford, Connecticut. Contributors in addition to Mr. O'Bryan and Mr. Hirschoff include Melissa DiVincenzo, of Morris, Nichols, Arsht & Tunnell LLP; Craig Menden, of SNR Denton; John R. Houston, of Robins, Kaplan, Miller & Ciresi LLP; Michael A. Pittenger, of Potter Anderson & Corroon LLP; Frederic L. Smith, Jr., of Bradley Arant Boult Cummings LLP; Patricia O. Vella, of Morris, Nichols, Arsht & Tunnell LLP; and Arthur J. Wright, of Thompson & Knight LLP. We also gratefully acknowledge the following Working Group members who assisted in the preparation of this year's *Annual Survey*: Byron Egan (Jackson Walker, LLP), Scott T. Whittaker (Stone Pigman Walther Wittmann L.L.C.), and the other members of the Working Group who assisted with the monitoring of judicial decisions and the selection of cases.

1. To be included in the *Annual Survey*, cases must meet two criteria:

First, the decision must involve a merger, an equity sale of a controlling interest, a sale of all or substantially all of a company's assets, a sale of a subsidiary or division, or a recapitalization resulting in a change of control.

Second, the court must (i) interpret or apply the provisions of an acquisition agreement or an agreement preceding an acquisition agreement (e.g., a letter of intent, confidentiality agreement, or standstill

Survey Summaries

No-Shop and Exclusivity Provisions and Preliminary Agreements

1. NACCO Industries, Inc. v. Applica Inc. (Breach of Contract, Fraud, Tortious Interference, and Civil Conspiracy Claims in Connection with Bidding Contest Survive Motion to Dismiss)

The Delaware Court of Chancery in *NACCO Industries, Inc. v. Applica Inc.*[2] denied the defendants' motion to dismiss claims arising from a bidding contest between NACCO Industries, Inc. ("NACCO"), a Delaware corporation, and various affiliates of Harbert Management Corp. (collectively referred to as "Harbinger") to purchase Applica Inc., a Florida corporation.[3]

Applica and NACCO signed a non-disclosure agreement in 2005, and amended it in February 2006 to include a standstill provision.[4] Applica also announced publicly that it was exploring strategic alternatives.[5] Applica and NACCO signed a merger agreement on July 23, 2006 (the "NACCO Agreement"), providing for the spin-off by NACCO of a subsidiary that would acquire Applica in a stock-for-stock merger and for the payment by the subsidiary of a cash dividend to NACCO prior to the spin-off.[6] The NACCO Agreement contained a no-shop provision limiting Applica's consideration of competing transactions to unsolicited offers and a covenant requiring Applica to notify NACCO promptly of any competing offer.[7]

agreement); (ii) interpret or apply a state statute (e.g., the general corporation law, the limited liability company law, or the partnership act of the applicable state) that governs one of the constituent entities; (iii) rule on a successor liability issue; or (iv) decide a breach of fiduciary duty claim.

Excluded are cases dealing exclusively with federal law, securities law, tax law, or antitrust law.

2. 997 A.2d 1 (Del. Ch. 2009).
3. *Id.* at 14.
4. *Id.* at 7.
5. *Id.*
6. *Id.*
7. *Id.* at 11, 14–15.

Harbinger began purchasing Applica shares in February 2006, and subsequently made several filings with the U.S. Securities & Exchange Commission pursuant to section 13 of the Securities Exchange Act of 1934.[8] Harbinger filed a Schedule 13D in May that disclosed a 24.7 percent position and stated that the shares were held for "investment purposes only," and in a subsequent filing in late June, disclosed a 32 percent stake and stated that the shares were held "for investment" (dropping the word "only").[9] Meanwhile, NACCO alleged, Harbinger had been in contact with Applica management about a potential transaction and had been tipped about the NACCO discussions.[10]

Around that time, Harbinger learned that its acquisition of Applica's stock had triggered the Florida Control Shares Act, under which it lost the right to vote its shares.[11] Harbinger contacted an Applica officer, "expressed dissatisfaction" with the NACCO Agreement, and, although the Applica officer indicated that Applica did not intend to invoke the statute, asked Applica to seek a shareholder vote to restore its voting rights.[12] Applica advised NACCO of Harbinger's request, and assured NACCO that Harbinger planned to vote for the NACCO Agreement.[13]

On September 14, Harbinger announced a bid to acquire all remaining Applica shares for $6.00 per share, topping the NACCO Agreement.[14] Harbinger also amended its Schedule 13D to state that the shares it then owned had been purchased "in order to acquire control of [Applica]."[15] Applica notified NACCO that it was engaging in discussions with Harbinger about its bid.[16] In October, Applica notified NACCO that it was terminating the NACCO Agreement in order to enter into an agreement with Harbinger.[17] NACCO claimed that Applica did not have the right to terminate, since Applica had breached the no-shop and notification provisions of the NACCO Agreement.[18] Several days later, Applica notified NACCO that it had terminated the NACCO Agreement, paid to NACCO the contractual $4 million termination fee plus $2 million in expense reimbursement, and entered into a merger agreement with Harbinger.[19]

Through January 2007, NACCO and Harbinger engaged in a bidding contest, with NACCO launching a tender offer and ultimately offering $8.05 per share, which was topped by Harbinger's offer of $8.25 per share.[20] On January 24, Applica stockholders approved the Harbinger merger proposal.[21]

NACCO brought suit against Applica and Harbinger, which moved to dismiss.[22]

8. *Id.* at 8.
9. *Id.* at 9.
10. *Id.*
11. *Id.* at 10.
12. *Id.*
13. *Id.* at 10–11.
14. *Id.* at 11.
15. *Id.*
16. *Id.*
17. *Id.* at 12.
18. *Id.*
19. *Id.*
20. *Id.* at 13.
21. *Id.*
22. *Id.*

Breach of Contractual No-Shop and Notice Requirements

First, the court held that the alleged facts supported a claim that Applica violated the no-shop and prompt notice provisions of the NACCO Agreement.[23] The court noted the different motivations Applica's management may have had with respect to a potential acquisition by NACCO, a strategic bidder likely to replace Applica management, as opposed to Harbinger, a financial bidder likely to keep current management in place.[24] The court also held that Applica's mere three communications with NACCO regarding Harbinger's offer, one of which was its notice of termination of the NACCO Agreement, constituted a failure to use "commercially reasonable efforts to keep NACCO informed."[25] Rather, Applica should have "regularly picked up the phone" to keep NACCO updated.[26]

The court rejected the defendants' argument that there were no damages because NACCO ultimately lost its bidding war with Harbinger.[27] The court noted that buyers bargain for provisions in acquisition agreements in order to have meaningful protection against "being used as a stalking horse" and are entitled to expectancy damages for breach of such provisions.[28] The argument for reliance damages was more tenuous given that NACCO received a termination fee and expense reimbursement, but the court noted that under the terms of the NACCO Agreement, a "willful and material breach" by Applica would preclude its right to terminate with limited liability.[29] The court declined to address an exact measure of damages.[30]

Fraud Based on Schedule 13D Filings

Second, the court held that NACCO sufficiently alleged common law (state) fraud claims against Harbinger based on statements in its section 13 filings indicating that Applica shares were acquired for investment purposes without any control intent.[31] Harbinger argued that its June filing in which it dropped the word "only" after stating that purchases were "for investment" sufficiently signaled a change of intent.[32] The court, however, found the change in language too subtle, calling it a "fig leaf," and further found that Applica's stated reservation of the right to take specified actions was insufficient when it was actively pursuing those actions.[33] The court also rejected the argument that in the hedge

23. *Id*. at 15–19.
24. *Id*. at 17.
25. *Id*. at 18.
26. *Id*.
27. *Id*. at 19.
28. *Id*.
29. *Id*.
30. *Id*.
31. *Id*. at 27–28.
32. *Id*.
33. *Id*. at 28.

fund community it was "widely believed" that it is not necessary to disclose any intent other than investment intent until a bid is actually made, noting that a recent case had rejected this "self-serving, formalistic, and bright-line interpretation."[34]

The court concluded that, while a "close call," NACCO was entitled to rely on Harbinger's section 13 disclosures in deciding how to negotiate with Applica.[35] Had NACCO been aware of Harbinger's plan before executing the NACCO Agreement, NACCO could have asked Applica to take responsive action, possibly through modification of the non-disclosure agreement's standstill provision or adoption of a rights plan, and, after executing the NACCO Agreement, NACCO also could have moved earlier to enforce the NACCO Agreement, possibly allowing for an expedited trial that could have led to the grant of an injunction or other relief.[36] The court acknowledged, though, that Applica had an interest in facilitating a topping bid, and so had some interest in allowing Harbinger to acquire some position.[37]

With respect to causally related damages, the court recognized again that it was a "close" question, given that NACCO may not have been able to close the merger even without Harbinger's fraud, but it allowed the claim at this stage.[38] NACCO argued that the fraud enabled Harbinger to amass a nearly 40 percent stake in Applica prior to the bidding war at a time when NACCO was restricted by its standstill agreement.[39] Thus, Harbinger was essentially "bidding with 60 cent dollars."[40]

Tortious Interference with Contract

Third, the court held that the alleged facts supported a claim for tortious interference with contract against Harbinger.[41] The court considered Harbinger's communications with Applica despite its knowledge of the no-shop and notice provisions in the NACCO Agreement as well as its fraudulent section 13 disclosures.[42] Recognizing that tortious interference claims must be balanced against the right to compete legitimately, the court found that Harbinger's false statements did not constitute "legitimate vehicles of competition."[43]

34. *Id.* (citing CSX Corp. v. Children's Inv. Fund Mgmt., 562 F. Supp. 2d 511 (S.D.N.Y.), *aff'd*, 292 F. App'x 133 (2d Cir. 2008)).
35. *Id.* at 29.
36. *Id.* at 30–31.
37. *Id.* at 31.
38. *Id.* at 32.
39. *Id.* at 33.
40. *Id.*
41. *Id.* at 33–35.
42. *Id.* at 34.
43. *Id.* (quoting Agilent Techs., Inc. v. Kirkland, No. 3512-VCS, 2009 WL 119865, at *8 (Del. Ch. Jan. 20, 2009)).

Civil Conspiracy

Fourth, with respect to the claim of civil conspiracy, the court held that Applica's communications with Harbinger before and after executing the NACCO Agreement and its failure to keep NACCO reasonably informed as to the status of discussions with Harbinger supported the claim at the pleadings stage, to the extent NACCO asserts Applica conspired with Harbinger to commit fraud.[44] However, the court dismissed the claim for civil conspiracy to the extent NACCO asserts that Harbinger and Applica conspired to breach the NACCO Agreement or to commit tortious interference with contract, holding that the concept of "efficient breach" allows parties to contract around tort liability for acts short of fraud.[45]

Implied Covenant of Good Faith and Fair Dealing and Equitable Fraud

Last, the court dismissed the plaintiff's claim for breach of the implied covenant of good faith and fair dealing on grounds that the terms of the NACCO Agreement, negotiated by "sophisticated" parties, "establish the scope of NACCO's rights . . . [and] leave no room for the implied covenant."[46] Likewise, the court dismissed the claim for equitable fraud because NACCO was a sophisticated party toward which the defendants had no special relationship.[47]

Conclusion

The *NACCO* case should remind M&A practitioners to ensure that target companies fulfill their notice obligations under no-shop provisions and comply with the no-shop provisions in communicating with potential bidders. In addition, practitioners representing potential bidders should reconsider the need to craft section 13 disclosures so as not to mislead the public.

2. Turner Broadcasting System, Inc. v. McDavid (Parties Bound by Oral Agreement Despite Language in Initial Letter of Intent Requiring Written Agreement)

In *Turner Broadcasting System, Inc. v. McDavid*,[48] a Georgia appellate court affirmed the trial court's denial of the defendant's motion for judgment notwithstanding the verdict or, alternatively, a new trial, after a jury entered a $281 million verdict for breach by Turner Broadcasting System, Inc. ("Turner") of an oral agreement to sell certain assets to McDavid for a purchase price of $96 million.[49]

In November 2002, Turner and McDavid began negotiating the sale of two sports teams and on April 30, 2003, signed a letter of intent ("LOI") outlining the proposed terms and establishing a 45-day exclusive negotiating period.[50] The

44. *Id.* at 36.
45. *Id.* at 35–36.
46. *Id.* at 20.
47. *Id.* at 33.
48. 693 S.E.2d 873 (Ga. Ct. App. 2010).
49. *Id.* at 882–83.
50. *Id.* at 876.

LOI stated that neither party "[would] be bound . . . unless and until such party (or affiliate) has executed the Definitive Agreements."[51] The LOI expired at the end of the exclusivity period, with only the confidentiality provisions stated to survive.[52]

The parties continued to negotiate. McDavid asked Turner about extending the LOI, but was told there was no need because they were "very, very close to a deal."[53] On a July 30 conference call, McDavid agreed to Turner's proposed resolution of an outstanding tax issue on the condition that it would finalize the deal, to which Turner's CEO responded, "[W]e have a deal."[54]

In August, the parties drafted the purchase agreement and exhibits and identified open drafting issues.[55] During this time, Turner drafted a memo to its employees (though the memo was not sent), prepared for a press conference to announce the deal, and consulted with McDavid on management decisions for one of the sports teams.[56] In mid-August, Turner proposed a transaction restructure, to which McDavid agreed based on assurances that the deal would not change and Turner was "ready to close on the deal that [they] made on July 30th."[57]

On August 20, another bidder, Atlanta Spirit, LLC, expressed an interest in purchasing the assets, and Turner entered negotiations with Atlanta Spirit.[58]

On September 12, Turner and McDavid "verbally reached a final agreement on each of the alleged open items for the written agreement" and Turner's principal negotiator stated, "The deal is done. Let's get documents we can sign."[59] That same day, however, Turner signed an agreement with Atlanta Spirit and, three days later, informed McDavid that the assets had been sold to another buyer.[60] McDavid subsequently filed suit for breach of an oral contract and promissory estoppel.[61]

Breach of Oral Contract

The jury found for McDavid on the breach of oral contract claim. On appeal, the court noted that the determination as to whether an oral contract existed presented issues of fact, and held that there was sufficient evidence to support the verdict.

51. *Id*. at 879 (quoting the LOI).
52. *Id*.
53. *Id*. at 876.
54. *Id*.
55. *Id*.
56. *Id*.
57. *Id*.
58. *Id*. at 877.
59. *Id*.
60. *Id*.
61. *Id*. Although the jury found in favor of McDavid on both claims, the $281 million judgment was entered on the breach of an oral contract claim and no judgment was entered on the promissory estoppel claim. *Id*. at 877 n.3. The promissory estoppel claim was not discussed in the court's opinion.

1. Parties' Intent to Be Bound. The court noted that whether there was mutual assent to a contract was determined pursuant to an "objective theory," with a party's intent deemed to be "that meaning a reasonable man in the position of the other contracting party would ascribe to the first party's manifestation of assent, or that meaning which the other contracting party knew the first party ascribed to his manifestations of assent."[62]

Expressions and Conduct. The court held that statements made by Turner representatives, such as "we have a deal" and the "deal is done," as well as Turner's drafting of an internal memo to employees, preparations for a press conference, and consultation with McDavid on management decisions supported a finding that Turner intended to be bound.[63]

Letter of Intent. The court acknowledged the LOI's express disclaimer that the parties would not be bound absent a written definitive agreement.[64] However, the court noted that Turner's failure to provide for survival of the written agreement requirement, in contrast to the confidentiality requirement, served as "some evidence contradicting Turner's claim that it maintained an objective manifestation to be bound only by a written agreement."[65] Further, after expiration of the LOI, Turner had not communicated its intent to be bound only by written agreement.[66] Thus, Turner's failure to renew the LOI upon McDavid's request suggested that "an oral agreement was not precluded."[67]

Contemplation of Written Instrument and Draft Integration Clause. While the parties' contemplation of a later written contract served as "strong evidence that [the parties] did not intend to be bound by a preliminary agreement," the jury was authorized to find the existence of a binding oral contract based on conflicting evidence of intent.[68] In addition to evidence discussed above, such conflicting evidence included the merger clause in the draft agreements circulated among the parties, which provided that the written agreement would "supersede all prior agreements, understandings and negotiations, both written and *oral*."[69] The court noted that such language could be viewed as an acknowledgment of the possibility of a previous oral agreement.[70]

2. Agreement Upon All Material Terms. Noting that the evidence presented was conflicting and presented a genuine issue of fact, the court held that the evidence supported the jury's determination that the parties had reached agreement on all material terms and that a binding oral agreement existed by September 12, when Turner told McDavid, "The deal is done."[71]

62. *Id*. at 878 (quoting McKenna v. Capital Res. Partners, IV, L.P., 650 S.E.2d 580, 583 (Ga. Ct. App. 2007) (internal citations omitted)).
63. *Id*. at 878–79.
64. *Id*. at 879.
65. *Id*.
66. *Id*. at 880.
67. *Id*.
68. *Id*.
69. *Id*. (emphasis added).
70. *Id*.
71. *Id*. at 883.

Damages

Turner further argued that the judgment should be reversed because there was no evidence that the condition for league approvals would have been met.[72] The court rejected this claim, noting that the requirement for league approvals was a condition subsequent that each party had, by entering into the agreement, made an implied promise to use "best efforts" to fulfill.[73] Turner's refusal to execute written agreements, which was a necessary first step in each party's ability to meet this condition, constituted a breach.[74] Thus, McDavid's nonperformance of the league approvals requirement was caused by Turner's breach and, as such, Turner's defense failed.[75]

Practical Implications

- The case emphasizes the importance of properly expressing the intent to be bound only by written agreement. The fact that the LOI provided for survival of the confidentiality provisions, but not the writing requirement, undermined Turner's position that the writing requirement was meant to continue throughout negotiations. Also notable was the court's statement that the merger clause in the draft definitive agreements could be construed as recognition by the parties that an oral contract may exist prior to the execution of a definitive agreement.
- The court's imposition of a "best efforts" obligation to fulfill the conditions to closing also is significant.

3. WaveDivision Holdings, LLC v. Millennium Digital Media Systems, L.L.C. (Seller Breached No-Solicitation and Reasonable Best Efforts Clauses in Purchase Agreements by Continuing to Seek Alternative Financing After Execution of the Purchase Agreements)

In *WaveDivision Holdings, LLC v. Millennium Digital Media Systems, L.L.C.*,[76] the Delaware Court of Chancery held that defendant Millennium Digital Media Systems, L.L.C. ("Millennium") breached the no-solicitation and reasonable best efforts provisions in certain purchase agreements between Millennium and plaintiff WaveDivision Holdings, LLC ("WaveDivision") that were governed by Delaware law.[77]

Millennium engaged in a series of refinancing transactions to maintain solvency, but by 2005 its secured senior lenders required that it sell its assets to repay its debts.[78] WaveDivision offered to purchase Millennium's cable systems, and the

72. *Id*. at 881.
73. *Id*. at 881, 884.
74. *Id*. at 881.
75. *Id*. at 885.
76. No. 2993-VCS, 2010 WL 3706624 (Del. Ch. Sept. 17, 2010).
77. *Id*. at *2.
78. *Id*. at *3–4.

parties signed a letter of intent containing an "Exclusivity of Negotiation" clause.[79] Despite the execution of the letter of intent, Millennium's CEO and an employee of Trimaran Fund Management, LLC, a fund holding certain of Millennium's increasing rate notes ("IRNs") and a de facto manager of Millennium, continued to seek refinancing alternatives to a deal with WaveDivision.[80]

Millennium later executed two purchase agreements for the sale of the cable systems to WaveDivision, both of which obligated Millennium not to shop for any other transactions and to use its reasonable best efforts to obtain the consent of its lenders to the purchase agreements.[81] Millennium's CEO and the Trimaran employee continued to seek and negotiate refinancing alternatives, especially with holders of the IRNs who would receive no debt repayment under a sale to WaveDivision.[82] Millennium even retained a consultant (at its own expense) to assist in developing an alternative refinancing plan.[83] Millennium eventually executed refinancing and restructuring agreements, transferring control to the IRN holders, and, on the same day, terminated the WaveDivision purchase agreements.[84]

WaveDivision brought an action for breach of contract against Millennium, alleging breach of the purchase agreements' no-solicitation and reasonable best efforts provisions and of the implied covenant of good faith and fair dealing.[85] The court rejected Millennium's argument that its performance under the purchase agreements was excused because a senior lender would not consent to the sale under any circumstances.[86] The court held that Millennium could not rely on a failure of the condition to excuse its performance when its own conduct materially caused the condition's failure.[87]

Millennium Breached No-Solicitation Clause

The court held that Millennium repeatedly breached the no-solicitation clauses in the agreements, including by acting as an "in house banker" for the IRN holders and by retaining its own financial advisor to explore financing alternatives to the sale to WaveDivision.[88] The court rejected Millennium's argument that enforcing the no-solicitation clause against it would cause its management committee to breach its fiduciary duties to its creditors, reasoning that Millennium decided to sell the cable systems at the behest of the senior lenders and with the approval of the IRN holders, and the whole point of the agreements was to pay off its creditors.[89] The court further noted that "Delaware entities are free to enter into bind-

79. *Id*. at *4.
80. *Id*. at *3, *6.
81. *Id*. at *7.
82. *Id*. at *8–12.
83. *Id*. at *8–9.
84. *Id*. at *13.
85. *Id*.
86. *Id*. at *14.
87. *Id*.
88. *Id*. at *16.
89. *Id*. at *17.

ing contracts without a fiduciary out so long as there was no breach of fiduciary duty involved when entering into the contract in the first place."[90]

Millennium Breached Reasonable Best Efforts Clauses

The court also held that Millennium breached the reasonable best efforts clauses in the purchase agreements and rejected Millennium's argument that its post-signing conduct was an attempt to obtain consent of its lenders.[91] The court cited Millennium's "lax attitude" toward the consent process, the fact that it "spent most of its energy" seeking alternatives to the sale to WaveDivision, and its failure to keep WaveDivision informed.[92]

Implied Covenant of Good Faith and Fair Dealing Is Not Applicable

The court held that the implied covenant of good faith and fair dealing was not applicable because the purchase agreements established the terms of the parties' relationship and the covenant could not be invoked to override those terms.[93]

Conclusion

The court's decision confirms that no-solicitation and best efforts clauses in purchase agreements are material and meaningful provisions that will be enforced by the Delaware courts. It also confirms that a company may be exposed to substantial damages, including expectation damages, for breaches of such provisions.

Rights of Preferred Stockholders

4. LC Capital Master Fund, Ltd. v. James (Preliminary Injunction Denied on Claim that Target Directors Breached Their Fiduciary Duties to the Preferred Stockholders in Allocation of Merger Consideration Between Common and Preferred Stockholders)

In *LC Capital Master Fund, Ltd. v. James*,[94] the Delaware Court of Chancery denied a preferred stockholder's motion to enjoin Francisco Partners II, L.P.'s ("Francisco's") acquisition of QuadraMed Corporation and held that directors do not owe a fiduciary duty to allocate additional merger consideration to the holders of preferred stock beyond the amounts provided for by the preferred stock terms.[95] In the merger agreement between QuadraMed and Francisco, the holders of preferred stock were to be treated on an as-converted-to-common basis.[96] The certificate of incorporation permitted the holders of preferred to convert to common

90. *Id.*
91. *Id.* at *18.
92. *Id.*
93. *Id.* at *19.
94. 990 A.2d 435 (Del. Ch. 2010).
95. *Id.* at 438.
96. *Id.*

and to receive the merger consideration available to the common, but did not specifically address how the merger consideration should otherwise be allocated to the preferred stock.[97]

QuadraMed began considering a sale of the company in 2008 and the board formed a special committee of independent directors to evaluate the bids.[98] Francisco's bid included a requirement that the preferred stock be cashed out on an "as-if converted" to common stock basis.[99] The special committee initially resisted cashing out the preferred stockholders, but agreed because of Francisco's insistence.[100] The special committee was advised by its counsel that so long as it honored the preferred stockholders' contract rights, it did not have to allocate additional consideration to the preferred; in fact, its counsel advised that it should be "careful" about allocating additional consideration to the preferred absent a special reason for doing so.[101]

The rights of the holders of the preferred stock were set forth in a certificate of designations.[102] The certificate gave the preferred stockholders the right to vote on various corporate actions, but not to vote on mergers.[103] The holders of preferred stock were not entitled to mandatory dividends.[104] The preferred stock had a liquidation preference, but a merger was not deemed to be a liquidation and the preferred stockholders had no right to force a liquidation.[105] The designation provided that the preferred stock was convertible at the option of the holder and also contained a mandatory conversion provision that allowed QuadraMed to convert the preferred stock into common stock, but only if the price of the company's common stock reached the liquidation preference.[106] The court characterized this bundle of preferred stock rights as creating a "bottom line" right of the preferred stockholders to be treated on an as-converted basis in a merger.[107]

Allocating to Preferred Stock Only the "Bottom Line" Consideration Owed to Them Under the Certificate of Designations Is Not Likely a Breach of Fiduciary Duties

The court emphasized that the plaintiff had not alleged that the board breached its "fiduciary duty to obtain the highest value reasonably attainable."[108] Rather, the plaintiff argued that the board should have allocated additional consideration

97. *Id.* at 440–41.
98. *Id.* at 441–42.
99. *Id.* at 442–43.
100. *Id.* at 443–44.
101. *Id.*
102. *Id.* at 438.
103. *Id.* at 440.
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.* at 440–41.
108. *Id.* at 438 (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)).

to the preferred stock based on the preferred stock's contract rights, e.g., its dividend right and liquidation preference.[109] The court rejected this argument and wrote:

> When, by contract, the rights of the preferred in a particular transactional context are articulated, it is those rights that the board must honor. To the extent that the board does so, it need not go further and extend some unspecified fiduciary beneficence on the preferred at the expense of the common. When, however, as in *Jedwab* and *FLS Holdings*, there is no objective contractual basis for treatment of the preferred, then the board must act as a gap-filling agency and do its best to fairly reconcile the competing interests of the common and preferred.[110]

Applying that rule, the court found that the board had no duty to allocate additional consideration to the preferred where (i) the preferred stockholders had no mandatory dividend right or voting rights in a merger, (ii) a merger did not trigger the preferred stockholders' liquidation preference, and (iii) the preferred stockholders received merger consideration based upon a specified contract right.[111] In dicta, the court posited what might be a "much harder case" to decide, that is, cashing out preferred stockholders with the right to mandatory dividends in circumstances where a discounted cash flow analysis would demonstrate that the company could make those payments, but where a merger did not trigger the preferred stock's liquidation preference.[112] The court reiterated that Delaware "law has not, to date, embraced the notion that Chancery should create economic value for preferred stockholders that they failed to secure at the negotiating table."[113] Similarly, the court rejected the plaintiff's suggested solution of appointing two special committees, each with its own set of advisors, to allocate the merger consideration between the common and the preferred stockholders because, in the court's view, that solution would give the preferred stockholders the ability to hold up a merger, a right for which they had not bargained.[114]

Special Committee Members Not Conflicted by Common Stock Holdings

The court then addressed whether the special committee members were interested in the merger because they held common but not preferred stock, and explained that, in general, the mere fact that independent directors hold only common stock is not sufficient to rebut the business judgment rule.[115]

Finally, the court also found that a balancing of the equities weighed against issuing an injunction because the preferred stockholders constituted a "concen-

109. *Id.*
110. *Id.* at 448–49.
111. *Id.* at 449.
112. *Id.* at 450 n.56.
113. *Id.*
114. *Id.* at 451.
115. *Id.* at 452–53 (citing Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997); *In re* Trados Inc. S'holder Litig., No. 1512-CC, 2009 WL 2225958, at *7 (Del. Ch. July 24, 2009)).

trated group of holders [that could] pursue appraisal and an equitable damages case."[116]

Conclusion

The decision emphasizes the court's preference for limiting preferred stockholders to their contract rights in situations arguably addressed by the certificate of designations and indicates its reluctance to create value for preferred stockholders for which they did not negotiate. The decision leaves open the possibility that the courts may use equity to fill "gaps" in the contract, but only where there is no objective contractual basis to use to determine the proper treatment of the preferred stockholders.

Fiduciary Duties

5. Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc. (Injunction Prohibiting Dissemination of Proxy Statement Pending Corrective Disclosures)

In *Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*,[117] the Delaware Court of Chancery enjoined a merger involving an acquisition of Plato Learning, Inc. by Thoma Bravo, LLC until corrective disclosures were made to PLATO's proxy statement.[118] The court ruled the proxy statement contained three materially misleading disclosures.[119]

Proxy Statement Contained Materially Misleading Description of Fairness Opinion

First, the proxy statement presented a materially misleading description of the investment banker's determination of the discount rate for its discounted cash flow analysis.[120] The proxy statement stated the investment banker selected discount rates "based upon an *analysis* of PLATO Learning's weighted average cost of capital"[121] when, in fact, the range of discount rates disclosed in the proxy statement was higher than the range of discount rates generated by the banker's analysis of PLATO's weighted average cost of capital ("WACC").[122] While testimony indicated that the investment banker believed that the higher range was more appropriate,[123] there was no "tangible evidence of any *actual analysis*" by the banker generating anything other than the lower range, nor was there any evidence that the banker provided any support for the higher range to PLATO's

116. *Id.* at 454.
117. No. 5402-VCS, 2010 WL 1931084 (Del. Ch. May 13, 2010).
118. *Id.* at *1.
119. *Id.*
120. *Id.*
121. *Id.* (emphasis added).
122. *Id.*
123. *Id.*

Special Committee.[124] The court ruled that since the proxy statement spoke on the discount rate used in the WACC analysis, there was a duty to do so in a non-misleading fashion.[125]

Proxy Statement Did Not Contain Management's Estimate of Future Cash Flow

Second, the proxy statement presented projections of PLATO's future performance without the free cash flow estimates that had been prepared by management and provided to the investment banker.[126] The court ruled that "management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information."[127]

Proxy Statement Failed to Disclose Potential Self-Interest of PLATO Management

Finally, the proxy statement disclosed that the Special Committee, in approving the merger, considered the fact that Thoma Bravo did not negotiate terms of employment, including compensation or equity participation, with management for the period after the closing.[128] The record showed that while there may have been no negotiations over a formal employment agreement, PLATO's CEO had extensive discussions with Thoma Bravo over typical equity incentives given by Thoma Bravo to management.[129] Furthermore, Thoma Bravo assured the CEO that it typically liked to keep existing management after an acquisition.[130] Thus the proxy statement, in the court's view, created a materially misleading impression that the management was given no expectations regarding the treatment they would receive following the merger.[131]

Conclusion

PLATO reminds M&A practitioners to scrutinize carefully the investment banker's fairness opinion analysis and board presentation to confirm the accuracy of disclosures in the proxy statement, and to be circumspect in disclosing discussions about management's future role and compensation expectations. It also reminds

124. *Id.*
125. *Id.* at *2.
126. *Id.*
127. *Id. Contra* Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. at 8–10 (Del. Ch. June 21, 2010) (denying plaintiffs' motion to expedite proceedings, in part, because there was no omission of material information where management never provided free cash flow estimates to the investment banker and there was therefore no deliberate removal or excising from the proxy disclosure as in *PLATO Learning*, but noting in dicta that the court would be willing to certify an interlocutory appeal to the Delaware Supreme Court on the question of whether Delaware law should require the disclosure of estimated free cash flows in the definitive proxy as a per se rule).
128. *Maric Capital Master Fund*, 2010 WL 1931084, at *2.
129. *Id.*
130. *Id.*
131. *Id.*

practitioners generally to disclose management's estimate of future free cash flow in a cash merger vote when the estimates have been included in the information considered by the investment banker or board of directors.

6. *In re* CNX Gas Corp. Shareholders Litigation (Applying "Unified Standard" to a Tender Offer Freeze-out, and Proposing Same Standard for Merger Freeze-outs, to Allow Judicial Review Under the Business Judgment Rule Rather than Entire Fairness Where the Transaction Is Conditioned on Both Special Committee Recommendation and Approval by a Majority of Unaffiliated Stockholders)

In *In re CNX Gas Corp. Shareholders Litigation*,[132] the Delaware Court of Chancery applied the "unified standard" to a freeze-out of minority shareholders by a majority shareholder structured as a tender offer followed by a second-step merger.[133] Under the unified standard, "the business judgment rule applies when a freeze-out is conditioned on *both* the affirmative recommendation of a special committee *and* the approval of a majority of the unaffiliated stockholders."[134] The special committee must be given authority to bargain with the controlling stockholder on an arm's length basis and there must not be a reason to question the effectiveness of the majority-of-the-minority tender condition.[135] If the freeze-out transaction fails in any of these particulars, entire fairness review will apply.[136]

CONSOL Energy, Inc. ("CONSOL") controlled CNX Gas Corporation ("CNX"), owning approximately 80 percent of CNX's common stock.[137] T. Rowe Price ("TRP") owned 6.3 percent of CNX's common stock and approximately 6.5 percent of CONSOL's outstanding common stock.[138] In March 2010, CONSOL and TRP agreed that CONSOL would make a tender offer for all CNX minority shares at $38.25 per share in cash and that TRP would tender within ten days of the tender offer's start.[139] CONSOL agreed to consummate a short-form merger promptly following a successful tender offer, at the same price.[140] The tender offer was subject to a non-waivable majority-of-the-minority condition, which minority included the TRP shares.[141]

After the announcement of the CONSOL/TRP tender agreement, the CNX board formed a special committee of CNX's single independent director with the authority to "review and evaluate the [t]ender [o]ffer" and "engage legal and financial advisors."[142] The special committee was not authorized to negotiate the tender

132. No. 5377-VCL, 2010 WL 2291842 (Del. Ch. May 25, 2010).

133. *Id*. at *1. The Vice Chancellor explained that the "unified standard" was first articulated in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005).

134. *CNX Gas*, 2010 WL 2291842, at *1.

135. *Id*.

136. *Id*.

137. *Id*. at *2.

138. *Id*.

139. *Id*. at *5.

140. *Id*.

141. *Id*.

142. *Id*. at *6.

offer or consider alternatives, and the full CNX board refused several requests by the special committee to expand its authority.[143] Ultimately, the special committee "determined not to express an opinion on the offer and to remain neutral," citing concerns about CONSOL's process for determining the merger consideration and its view that CONSOL was unwilling to negotiate on price.[144]

Certain CNX minority shareholders challenged the freeze-out merger as unfair and sued for a preliminary injunction ahead of the scheduled closing of the tender offer.[145]

The Unified Standard

The court observed that "Delaware law applies a different standard of review depending on how a controlling stockholder freeze-out is structured,"[146] in that a single-step merger between a controlling stockholder and its subsidiary is reviewed for entire fairness, while "a controller's unilateral tender offer followed by a short-form merger is reviewed under an evolving standard far less onerous than *Lynch*."[147] The court concluded that a "unified standard" of review should apply to freeze-outs structured as either a single-step merger or a two-step tender offer and merger.[148] Under the unified standard, the business judgment rule applies if *both* of the following are used:

(1) a majority-of-the-minority voting provision, and
(2) a special committee of independent directors that affirmatively recommends the transaction.[149]

Applying the "unified standard," the court ruled that CNX's special committee could not justify application of the business judgment rule because the special committee did not actually recommend the tender offer.[150] Moreover, the special committee's authority was insufficient because it was not empowered to negotiate or consider alternatives, or to deploy a rights plan.[151] The court reasoned that special committees should have the same powers that an independent board would have.[152]

Role of Minority Shareholders in Applying Majority-of-the-Minority Conditions

The court also reasoned that TRP's role in the tender offer may have "undercut the effectiveness of the majority-of-the-minority tender condition."[153] The

143. *Id.*
144. *Id.*
145. *Id.* at *1.
146. *Id.* at *7.
147. *Id.* (citing *In re* Siliconix, Inc. S'holders Litig., No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001)).
148. *Id.* at *12–14.
149. *Id.* at *1.
150. *Id.* at *14.
151. *Id.* at *16.
152. *Id.*
153. *Id.*

court emphasized that TRP was CNX's largest minority stockholder, CONSOL had "elected to pre-negotiate the terms of the [t]ender [o]ffer with TRP, a third-party non-fiduciary, rather than negotiating with the [s]pecial [c]ommittee," and the special committee itself had concerns about TRP's role in the tender offer.[154]

Despite finding that the tender offer would be reviewed for entire fairness, the court denied a preliminary injunction because a post-closing award of monetary damages would remedy any harm to plaintiffs.[155]

Interlocutory Appeal Certified but Denied

After the merger closed, the court certified an interlocutory appeal, reasoning that the Delaware Supreme Court needed to resolve the "doctrinal bramble" surrounding the different standards that might be used to review a controlling stockholder's two-step freeze-out of the minority.[156] The "bramble" consists of three competing case lines:

(1) the *Cox Communications* line, including the Vice Chancellor's "unified standard," under which a two-step freeze-out is presumptively subject to the business judgment rule if it is "(i) recommended by a duly empowered special committee of independent directors and (ii) conditioned on the affirmative tender of a majority of the minority shares";[157]

(2) the *In re Pure Resources Shareholders Litigation*[158] line, under which a two-step freeze-out is not reviewed for substance if "(i) it is subject to a non-waivable majority of the minority tender condition; (ii) the controlling stockholder promises to consummate a prompt short-form merger at the same price if it obtains more than 90% of the shares; (iii) the controlling stockholder has made no retributive threats; and (iv) the independent directors on the target board have free rein and adequate time to react to the tender offer";[159] and

(3) the *Siliconix* line, under which a unilateral two-step freeze-out transaction is reviewed for entire fairness only if the offer is structurally coercive.[160]

Unfortunately, the Delaware Supreme Court denied the application for interlocutory review, so the "doctrinal bramble" remains.[161]

154. *Id.* at *17.
155. *Id.* at *21.
156. *In re* CNX Gas Corp. S'holders Litig., No. 5377-VCL, 2010 WL 2705147 (Del. Ch. July 5, 2010).
157. *Id.* at *3.
158. 808 A.2d 421 (Del. Ch. 2002).
159. *CNX Gas*, 2010 WL 2705147, at *4.
160. *Id.*
161. *In re* CNX Gas Corp. S'holders Litig., No. 333, 2010 WL 2690402 (Del. July 8, 2010).

7. Versata Enterprises, Inc. v. Selectica, Inc. (Upholds Adoption, Triggering, and "Reloading" of a 4.99 Percent Rights Plan to Protect Net Operating Loss Carryforwards)

On October 4, 2010, the Delaware Supreme Court, in *Versata Enterprises, Inc. v. Selectica, Inc.*,[162] affirmed the Court of Chancery's determination that the protection of net operating loss carryforwards ("NOLs") may be an important corporate policy that can be defended with appropriate measures and upheld the adoption, triggering, and "reloading" of a shareholder rights plan (commonly known as a "poison pill") designed to protect NOLs.[163] At issue was a shareholder rights plan with a 4.99 percent triggering threshold, implemented by Selectica ostensibly to protect Selectica's $160 million in NOLs against an ownership change under section 382 of the Internal Revenue Code.[164]

Selectica had previously adopted its rights plan with a 15 percent trigger.[165] Selectica also had reviewed with independent financial and accounting experts the potential value of its NOLs and their vulnerability to an ownership change under section 382.[166] On November 14, 2008, after rejecting several unsolicited takeover offers from Trilogy, Inc. and its affiliate Versata Enterprises, Inc. (collectively, "Trilogy"), Selectica's board reduced the trigger to 4.99 percent.[167] Selectica's advisors had reported to the board that additional acquisitions of approximately 10 percent of Selectica's shares by new or existing 5 percent holders, including Trilogy, would result in an ownership change and permanent devaluation of Selectica's NOLs.[168] Trilogy, a competitor of Selectica, already owned approximately 6.1 percent of Selectica's stock, but was exempted as an existing beneficial owner under the plan.[169] However, in December 2008, Trilogy purchased additional shares in excess of its exemption in an apparent attempt to trigger the rights plan.[170]

Selectica's rights plan allowed Selectica's board to declare Trilogy an exempt person during the ten-day period following the trigger, if the board determined that Trilogy would not jeopardize its NOLs.[171] However, after three failed attempts to negotiate a standstill agreement with Trilogy, and several board meetings, including discussions with its financial and accounting advisors, Selectica's board chose not to declare Trilogy exempt,[172] and instead implemented an exchange under the

162. 5 A.3d 586 (Del. 2010).
163. *Id.* at 588–89.
164. *Id.* Section 382 limits the amount of NOLs that can be used to reduce tax obligations in periods following an ownership change. *Id.* at 589.
165. *Id.* at 594.
166. *Id.*
167. *Id.* at 594–95.
168. *Id.* at 594.
169. *Id.* at 595–96.
170. *Id.* at 596.
171. *Id.*
172. *Id.* at 596–98.

rights plan, which diluted Trilogy's holding from 6.7 percent to 3.3 percent.[173] Selectica also declared a new rights dividend, to "reload" its rights plan.[174]

Unocal *Standard Applies*

The court found that the rights plan operates as an antitakeover device and must be analyzed under the analysis established in *Unocal Corp. v. Mesa Petroleum Co*.[175] Under *Unocal*, a board will be afforded the protections of the business judgment rule with respect to its adoption of a defensive measure if (1) it had reasonable grounds for concluding that a threat to the corporate enterprise existed and (2) the defensive action was reasonable in relation to the threat identified.[176]

Threat Reasonably Identified

The court found that the potential loss of NOLs constituted a cognizable threat under *Unocal* because Selectica's board "acted in good faith reliance on the advice of experts in concluding that the 'NOLs were an asset worth protecting and thus, that their preservation was an important corporate objective.'"[177] Notwithstanding the fact that the value of net operating loss carryforwards is inherently incapable of being determined, and might be zero if Selectica fails to realize future profits, the court recognized that a section 382 ownership change would impair significant potential shareholder value.[178]

Preclusiveness and Reasonableness

The court then determined that the defensive measures taken by Selectica's board were a reasonable response to the threat of impairment of Selectica's NOLs.[179] Citing *Unitrin*, the court stated that a defensive measure is disproportionate and therefore unreasonable per se if it is either coercive or preclusive.[180] The court defined coercive and preclusive actions as those that force a management-sponsored alternative upon shareholders or render a successful proxy contest realistically unattainable.[181] The court found no evidence that a challenger starting below 5 percent could not realistically hope to prevail in a proxy contest.[182]

If a defensive measure is neither coercive nor preclusive, the *Unocal* proportionality test requires that it be a reasonable response to the perceived threat.[183]

173. *Id*. at 599.

174. *Id*. at 598.

175. *Id*. at 599 (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)).

176. *Id*. at 599–601 (citing *Unocal*, 493 A.2d at 955).

177. *Id*. at 600.

178. *Id*. at 589, 599–601.

179. *Id*. at 601–07.

180. *Id*. at 601 (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387 (Del. 1995)).

181. *Id*. (quoting Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1195 (Del. Ch. 1998) (quoting *Unitrin*, 651 A.2d at 1389)).

182. *Id*. at 604.

183. *Id*. at 605 (citing *Unitrin*, 651 A.2d at 1388 (quoting Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45–46 (Del. 1994))).

The court held that the defensive measures were a reasonable response because Selectica's board determined, in reliance on independent experts, that the NOLs were a corporate asset worth protecting and that the NOLs were at risk as a result of Trilogy's actions.[184] Moreover, the 4.99 percent threshold in the rights plan was well-tailored to confront the threat because the threshold was based on section 382 rules for calculating ownership change, and not arbitrarily chosen by Selectica.[185] The court also found that the exchange feature employed by the board was a more proportionate response than the "flip-in" mechanism that would have further diluted Trilogy's position.[186] Finally, the court noted that "[a]fter three failed attempts to negotiate with Trilogy, it was reasonable for the Board to determine that they had no other option" than to implement the rights plan.[187]

Context Determines Reasonableness

The court's decision indicates that a poison pill with a trigger below 15 percent is not per se invalid. However, the court cautioned that "the reasonableness of a board's response is determined in relation to the 'specific threat,'" and that in this instance "a longtime competitor sought to increase [its ownership] percentage . . . , not for the purpose of conducting a hostile takeover but, to intentionally impair corporate assets, or else coerce Selectica into meeting certain business demands."[188] Only in relation to this specific threat has the court considered the reasonableness of Selectica's defensive measures.

8. Yucaipa American Alliance Fund II, L.P. v. Riggio (Poison Pill Rights Plan Held Reasonable Response to Takeover Threat Because It Did Not Fundamentally Restrict Insurgent from Winning a Proxy Contest)

In *Yucaipa American Alliance Fund II, L.P. v. Riggio*,[189] the Delaware Court of Chancery held that the decision of the board of directors of Barnes & Noble, Inc. to adopt a poison pill rights plan with a 20 percent threshold and a provision that grandfathered the company's founder but limited his stake to its existing level was a reasonable response to a threat to Barnes & Noble and its stockholders.

Unhappy with the direction of Barnes & Noble, Ronald Burkle, through certain of his investment funds ("Yucaipa"), doubled his ownership interest in Barnes & Noble to nearly 18 percent over a four-day period.[190] In response, the Barnes & Noble board adopted the rights plan, which prevented a single stockholder or group of stockholders from accumulating more than 20 percent of Barnes & No-

184. *Id.* at 606.
185. *Id.*
186. *Id.*
187. *Id.*
188. *Id.* at 606–07 (internal citations omitted).
189. 1 A.3d 310 (Del. Ch. 2010).
190. *Id.* at 312.

ble's outstanding stock.[191] The rights plan exempted the holdings of Barnes & Noble's founder and chairman, Leonard Riggio, and his affiliates and associates (which totaled nearly 30 percent), but provided that any increase in Riggio's ownership (with limited exceptions) would trigger the rights plan.[192] Yucaipa filed suit and claimed that the board breached its fiduciary duties by adopting the rights plan and by failing to amend it to increase the triggering threshold in accordance with Burkle's request.[193]

Majority of Board Was Independent and Acted in Good Faith

The court first determined that five of the board's nine directors were independent.[194] Although the court observed that the board's process when considering the rights plan was imperfect, the court concluded that the independent directors who comprised the majority of the board had acted reasonably and in good faith to protect the company and its stockholders and not to perpetuate Leonard Riggio as the largest stockholder or otherwise further his interests.[195]

Unocal *Is Applicable Standard of Review, Not Entire Fairness or* **Blasius**

Yucaipa argued that the standard of review should be either the entire fairness standard or the *Blasius* compelling justification standard.[196] The court rejected the entire fairness standard because the rights plan prevented Riggio from increasing his stake and did not grant him any special benefit.[197] The court held that the *Blasius* standard did not apply because it could not conclude that the board's primary purpose was to disenfranchise Barnes & Noble's stockholders.[198] The court found that the board adopted the rights plan to protect the company and its stockholders from the threat posed by Yucaipa's rapid stock purchases and its stated intent in public disclosures to purchase up to 50 percent of the shares.[199] The court held that the adoption and utilization of the rights plan as a defensive measure was subject to enhanced scrutiny review under the *Unocal* standard.[200]

Customary Definition of "Beneficial Ownership" in Rights Plan Was Not Unreasonable

Yucaipa attempted to distinguish prior cases applying *Unocal* review to the adoption and utilization of a rights plan by arguing that the Barnes & Noble rights plan unfairly and unreasonably prevented Yucaipa from forming a coalition with

191. *Id*. at 312–13.
192. *Id*.
193. *Id*. at 313.
194. *Id*. at 435–46.
195. *Id*.
196. *Id*. at 329 (citing Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661–62 (Del. Ch. 1988)).
197. *Id*. at 329–30.
198. *Id*. at 330–36.
199. *Id*. at 331.
200. *Id*. at 329.

another significant stockholder to run a proxy contest to elect new directors.[201] The court noted that it was not unprecedented for a rights plan to restrict the ability of stockholders collectively owning more than 20 percent of the outstanding shares from forming a group to promote a joint slate of directors, and held that such a rights plan does not disenfranchise any stockholders in the sense of preventing them from freely voting or soliciting revocable proxies.[202]

The court also rejected Yucaipa's argument that the rights plan's definition of "beneficial ownership" was ambiguous and, therefore, unreasonable.[203] The court determined that the rights plan's trigger was based on a well-recognized standard, which sophisticated investors such as Yucaipa must address regularly and which has been the subject of many judicial proceedings.[204]

Rights Plan Did Not Unreasonably Restrict Stockholders' Ability to Run a Proxy Contest

Although the court rejected Yucaipa's arguments to the effect that the rights plan's restrictions on group formation and its definition of "beneficial ownership" were per se unreasonable, it emphasized that the *Unocal* analysis nevertheless required the court to consider whether the rights plan unreasonably restricted the ability of stockholders to run a proxy contest given the significant block of Barnes & Noble stock owned by Leonard Riggio.[205] Vice Chancellor Strine noted that he did not espouse the view that rights plans are not preclusive if they merely provide "a mathematical or theoretical possibility of winning a proxy contest."[206] A rights plan could be deemed preclusive, in the court's view, if it did not grant a proxy insurgent a "fair chance for victory."[207] The court stated that when a rights plan "both prevents a tender offer and unfairly tilts the electoral playing field against an insurgent, this court . . . should not hesitate to enjoin its operation."[208]

Rights Plan Was a Proportionate Response to Threat Posted by Yucaipa

Noting that Yucaipa abandoned its argument that the board did not reasonably believe Yucaipa's actions posed a threat to Barnes & Noble, the court considered whether the adoption of the rights plan was reasonable in relation to the threat.[209] The court held that the rights plan was a proportional response to a legitimate threat to corporate policy by Yucaipa.[210] The court rejected Yucaipa's contention that the Riggio family's 30 percent stake made the rights plan's 20 percent threshold unreasonable because it inhibited Yucaipa from running an effective proxy

201. *Id.* at 332.
202. *Id.* at 332–33.
203. *Id.* at 338–44.
204. *Id.*
205. *Id.* at 340–41.
206. *Id.* at 337 n.182.
207. *Id.*
208. *Id.*
209. *Id.* at 338.
210. *Id.* at 360.

contest.[211] The court noted that Yucaipa likely could obtain half the necessary votes from one other stockholder, Aletheia Research and Management, Inc. ("Aletheia"), which had a history of shadowing Burkle's investments and which had followed Yucaipa's investment in Barnes & Noble by increasing its own stake from 6.37 percent to 17.44 percent.[212]

Board Acted Reasonably in Not Amending the Rights Plan to Permit Yucaipa to Increase Its Stake

Yucaipa also claimed the board's failure to amend the rights plan to increase the triggering threshold to 37 percent, which would have permitted Yucaipa and Aletheia jointly to run a proxy contest, was not within the range of reasonable responses.[213] The court found that the board's decision not to amend the rights plan was reasonable because the board had good cause for concern that Yucaipa and Aletheia would join together to take effective control of Barnes & Noble.[214]

9. Arkansas Teacher Retirement System v. Caiafa (Rejecting Argument that Directors Have Fiduciary Duty to Value or Preserve Piecemeal Assets in a Merger Setting and Noting that Based on Facts of Case Had Fraud Claim Based on Pre-Merger Facts Been Successfully Pleaded, Claim Would Have Survived Post-Merger)

In *Arkansas Teacher Retirement System v. Caiafa*,[215] the Delaware Supreme Court affirmed the Court of Chancery's approval of a settlement relating to claims involving the merger of Countrywide Financial Corp. ("Countrywide") with Bank of America ("BOA"), but noted in dicta that although the plaintiffs in a separate derivative action lost standing as a result of the merger, the Countrywide directors' conduct may have justified a separate direct claim of fraud that would have survived the merger.

In the fall of 2007, several stockholders of Countrywide, including Arkansas Teacher Retirement System ("TRS"), filed a derivative suit against the Countrywide directors in a federal district court in California alleging that certain board members breached their fiduciary duties by abandoning prudent lending practices, engaging in illegal insider sales, and manipulating the company for personal gain.[216] While the derivative suit was pending, the Countrywide board approved a stock-for-stock merger with BOA in which Countrywide stockholders received BOA stock in exchange for their Countrywide stock.[217]

211. *Id.* at 353–60.
212. *Id.* at 324–25.
213. *Id.* at 338.
214. *Id.* at 345–46.
215. 996 A.2d 321 (Del. 2010).
216. *In re* Countrywide Corp. S'holders Litig., No. 3464-VCN, 2009 WL 846019, at *4 (Del. Ch. Mar. 31, 2009).
217. *Id.* at *2.

Stockholders File Suit Over Merger, then Settle, in Court of Chancery

After the merger was announced, several Countrywide stockholders filed a class action suit in Delaware alleging that Countrywide directors had violated their fiduciary duties.[218] These stockholders eventually negotiated a settlement with the Countrywide directors under which virtually all claims surrounding the merger were released.[219] After the merger closed, TRS's derivative suit pending in federal court was dismissed because TRS no longer owned shares of Countrywide stock.[220]

Court of Chancery Approves Settlement Over Stockholder Objections

Exception Not Shown to General Rule that Loss of Stock Ownership in Merger Extinguishes Standing to Pursue Derivative Claims. TRS objected to the settlement, arguing that it was fundamentally unfair because the settlement had allowed BOA to close its acquisition of Countrywide, thereby extinguishing TRS's standing to pursue derivative claims it believed could have amounted to as much as $2 billion.[221] The court noted that the extinguishment of standing was a function of Delaware corporate law, not the settlement agreement, explaining that while the settlement specifically carved out derivative claims, the loss of standing was a function of fundamental Delaware law: "[I]t is well established that a merger which eliminates a derivative plaintiff's ownership of shares of the corporation for whose benefit she has sued terminates her standing to pursue those derivative claims."[222]

The court also explained, however, that where the merger eliminating a derivative plaintiff's ownership of shares, and thus standing to pursue derivative claims, has been "perpetrated merely to deprive shareholders of the standing to bring a derivative action," the case is excepted from the derivative standing rule.[223] The court noted that TRS had not presented evidence that the merger was a pretext, recognizing that while it could not conclude that the directors of Countrywide were oblivious to the additional benefit of the merger of avoiding derivative liability, avoiding liability was neither the only nor the principal reason for supporting the transaction.[224]

Direct Liability of Directors Not Shown. TRS also argued that the Countrywide directors were *directly* liable for breach of fiduciary duty for (i) failing to value the derivative claims at the time the merger was negotiated and (ii) failing to preserve such value, either by extracting additional consideration from BOA or by assigning the derivative claims to a litigation trust that could pursue the claims for the benefit of Countrywide's stockholders.[225] The court rejected those claims, noting

218. *Id.*

219. *Id.* at *3. The derivative claims brought by TRS were not part of the release; BOA would have the option of pursuing those claims against former Countrywide directors after the merger if it so chose. *Id.* at *4.

220. *Id.* at *4.

221. *Id.*

222. *Id.* at *6 (quoting Lewis v. Ward, 852 A.2d 896, 900–01 (Del. 2004)).

223. *Id.* at *7 (quoting *Lewis*, 852 A.2d at 902).

224. *Id.*

225. *Id.* Both such claims would be released under the terms of the settlement. *Id.* at *7 n.42.

that TRS did not show that the consideration paid by BOA was unfair, there was no basis to believe BOA could have been persuaded to pay more for Countrywide because of the derivative claims, and there was no basis to require the board to value separately the derivative claims or set them aside to preserve their value.[226]

Delaware Supreme Court Affirms

On appeal, the Delaware Supreme Court affirmed, finding that the Court of Chancery appropriately denied TRS's objections "because Delaware corporate fiduciary law does not require directors to value or preserve piecemeal assets in a merger setting."[227]

The Delaware Supreme Court, however, noted that the conduct TRS alleged Countrywide directors had engaged in was "wholly inappropriate for Delaware corporate directors."[228] The Delaware Supreme Court reasoned that TRS had pleaded facts supporting a colorable claim of pre-merger fraud, and that it was plausible that when the allegedly fraudulent pre-merger conduct of the Countrywide directors pushed Countrywide to the brink of bankruptcy, the directors looked to BOA as a "fiduciary White Knight" that could acquire Countrywide and absolve them from derivative liability.[229] The Delaware Supreme Court reasoned that it would not matter whether this "plausible scenario" was a "single, cohesive plan" of the directors or a "snowballing pattern of fraudulent conduct and conscious neglect."[230] Either way, if TRS had successfully pleaded its fraud claim, TRS could have maintained a post-merger claim and potentially recovered monetary damages from the former Countrywide directors.[231]

10. Brown v. Brewer (Bad Faith Breach of Duty of Loyalty Claims Survive Motion for Summary Judgment in Multiple-Bidder Acquisition)

In *Brown v. Brewer*, the U.S. District Court for the Central District of California applied Delaware law in denying the defendants' motion for summary judgment with respect to claims arising from News Corp.'s 2005 acquisition of Intermix Media, Inc.[232] The complaint alleged that Rosenblatt, the CEO and a director of Intermix, breached his duty of good faith by favoring the bid by News Corp. to the exclusion of other potential bids for reasons other than maximizing shareholder value,[233] and that the other directors breached their duty of good faith by approving the acquisition of Intermix by News Corp. without sufficient information.[234]

226. *Id.* at *7–9.
227. Ark. Teacher Ret. Sys. v. Caiafa, 996 A.2d 321, 322 (Del. 2010).
228. *Id.*
229. *Id.* at 323.
230. *Id.*
231. *Id.* at 323–24.
232. Brown v. Brewer, No. CV 06-3731-GHK(SHx), 2010 WL 2472182, at *10 (C.D. Cal. June 17, 2010).
233. *Id.* at *10.
234. *Id.* at *13.

The plaintiffs presented evidence that during the week before execution of the merger agreement with News Corp., Rosenblatt stonewalled advances by Viacom Inc., which was preparing to make a rival bid for Intermix.[235] The plaintiffs alleged that Rosenblatt was self-interested in getting a deal done with News Corp. because News Corp. had offered him a post-acquisition position.[236] Moreover, Rosenblatt served on the Intermix Board's Transaction Committee and became solely responsible for communicating updates to the Intermix Board regarding the potential acquisition by News Corp. or Viacom.[237] The court determined that Rosenblatt was the only board member with first-hand knowledge of Viacom's efforts to make a rival bid.[238] The plaintiffs presented additional evidence that the Intermix Board did not do any independent research or analysis regarding the fairness of the News Corp. bid or the possibility of a topping bid by Viacom.[239] In analyzing these claims, the court focused on (1) whether Rosenblatt impermissibly tilted the playing field in favor of News Corp., and (2) whether the remaining board members consciously disregarded their duties by failing to investigate.[240]

Rosenblatt

The court reviewed e-mails sent by Rosenblatt discussing his post-merger employment prospects with News Corp. and found that they were sufficient to "at least raise[] the inference that Rosenblatt had a strong interest in seeing a merger transaction with News Corp. completed and had made up his mind that Intermix would be sold to News Corp."[241] The court also reviewed evidence that Rosenblatt deliberately stonewalled Viacom while waiting for the News Corp. bid.[242] Rosenblatt's alleged conduct included failing to return phone calls and e-mails from Viacom and its representatives, presenting the potential Viacom bid to the Board as a "pipedream," and misleading Viacom about the timing of the News Corp. bid.[243] The court, therefore, found there was at least a triable issue of fact as to whether Rosenblatt's conduct had an effect on Viacom's failure to make a timely bid for Intermix.[244]

The court discussed this conduct in the context of whether it constituted bad faith for purposes of a breach of the duty of loyalty.[245] The court stated that *Lyondell v. Ryan*[246] involved only one bidder and that "we do not read *Lyondell* as diminishing the prohibition on tilting the playing field in favor of a particular bidder for any reason other than maximizing shareholder wealth."[247] The court held there

235. *Id.* at *11–13.
236. *Id.* at *11.
237. *Id.* at *13.
238. *Id.*
239. *Id.* at *13–14.
240. *Id.* at *14.
241. *Id.* at *11.
242. *Id.* at *11–13.
243. *Id.*
244. *Id.* at *13.
245. *Id.* at *6–10.
246. Lyondell Chem. Co. v. Ryan, 970 A.2d 235 (Del. 2009).
247. *Brewer*, 2010 WL 2472182, at *10.

was a triable issue of fact about whether Rosenblatt's actions could constitute bad faith sufficient for a breach of the duty of loyalty.[248]

The Other Board Members

The court noted that the Intermix Board formed a Transaction Committee that was comprised of Rosenblatt and two other Intermix Board members.[249] The court then observed that the Board received most of its information about the negotiations from Rosenblatt.[250] Moreover, there was evidence suggesting that "no one on the Board answered any questions about the requested per share price, the treatment of the competing bidders, the fairness valuations, or the relative likelihood of a Viacom bid."[251] The court concluded that there was sufficient evidence to create a triable question as to whether the rest of the Intermix board "'plac[ed] the entire process in the hands of' Rosenblatt and . . . 'materially contributed to the [allegedly] unprincipled conduct of those upon whom it looked with a blind eye.'"[252]

The court then discussed the existing law that defines what level of failing to investigate reaches the level of actionable bad faith.[253] The court first cited *Gesoff v. IIC Industries, Inc.*,[254] in which the court held that bad faith may be found where directors have "acted with conscious disregard or made decisions with knowledge that they lacked material information."[255] The court went on to state that there is agreement that "'adopting a 'we don't care about the risks' attitude concerning a material corporate decision' constitutes bad faith."[256] The court quoted *In re Walt Disney Co. Derivative Litigation* and stated that a bad faith claim is properly alleged if "the directors knew that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decisions cause the corporation and its stockholders to suffer injury or loss."[257] The court concluded that there was a triable question whether the other Intermix Board members had "exceeded the bounds of negligent conduct, willfully proceeded to their decisions knowing they lacked material information, and thereby consciously disregarded their fiduciary duties."[258]

Conclusion

Brewer illustrates how a federal district court located in California interprets current Delaware law relating to breach of the duty of loyalty based upon bad

248. *Id.*
249. *Id.* at *13.
250. *Id.*
251. *Id.* at *14.
252. *Id.* at *13 (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1281 (Del. 1989)).
253. *Id.*
254. 902 A.2d 1130 (Del. Ch. 2006).
255. *Brewer*, 2010 WL 2472182, at *13 (quoting *Gesoff*, 902 A.2d at 1165).
256. *Id.* (quoting *In re* Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003)).
257. *Brewer*, 2010 WL 2472182, at *13 (quoting *Disney*, 825 A.2d at 289).
258. *Id.* at *14 (internal citations omitted).

faith. Among other things, it reinforces the holding in *Lyondell* and other cases that a conscious disregard of known duties can constitute actionable bad faith, and makes clear that *Lyondell* does not diminish prior case law prohibiting favoring one bidder over another.

Earn-outs and Contractual Obligations

11. Airborne Health, Inc. v. Squid Soap, L.P. (Dismissal of Contract and Fraud Claims in an Earn-out Transaction)

In *Airborne Health, Inc. v. Squid Soap, L.P.* (*Airborne No. 2*),[259] the Delaware Court of Chancery dismissed a counterclaim for extra-contractual fraud against Airborne Health, Inc. ("Airborne") and its counsel, Weil, Gotshal & Manges, LLP ("Weil"), in connection with the purchase by Airborne of the assets of Squid Soap, L.P. ("Squid") in exchange for an up-front cash payment and a potential earn-out.[260] In its earlier opinion the court dismissed other counterclaims by Squid.[261]

In early 2007, Squid Soap and Airborne entered into an Asset Purchase Agreement (the "APA") in which Squid Soap agreed to sell its assets for one million dollars cash at closing plus the potential for earn-out payments of up to $26.5 million if certain targets were achieved.[262] The APA provided that if the purchaser did not incur at least one million dollars in marketing, advertising, and related expenses specifically focused on Squid Soap products within twelve months after closing and net sales of Squid Soap products did not reach five million dollars within that period, the purchaser would be required to return the assets to Squid Soap for nominal consideration.[263] The APA did not, however, require the purchaser to devote any particular level of efforts or resources to the marketing of Squid Soap products.[264]

Squid Soap alleged that at the time of the closing, it was unaware of (1) news reports of a special ABC investigation severely critical of Airborne's germ-fighting product; (2) a class action filed in May 2006 against Airborne in California state court asserting claims for false advertising, consumer fraud, deceptive or unfair business practices, and unfair competition; and (3) suits against Airborne for false marketing by the U.S. Federal Trade Commission and the attorneys general for thirty-two states.[265] Squid Soap further alleged that due to these legal difficulties, Airborne did nothing to market Squid Soap, and these difficulties "killed Squid Soap in its infancy."[266] Since marketing expenses and sales did not reach the levels specified in the APA, Airborne was required to return the assets to Squid Soap, and attempted to do so.[267]

259. No. 4410-VCL, 2010 WL 2836391 (Del. Ch. July 20, 2010).
260. *Id.* at *10.
261. *See* Airborne Health, Inc. v. Squid Soap, L.P., 984 A.2d 126 (Del. Ch. 2009) (Airborne No. 1).
262. *Id.* at 132.
263. *Id.*
264. *Id.* at 133.
265. *Id.* at 134.
266. *Id.* at 135.
267. *Id.*

Airborne and Weil sought a declaratory judgment from the Delaware Court of Chancery that they were not liable under the APA,[268] and Squid Soap asserted counterclaims.[269]

Fraudulent Inducement

Squid Soap asserted that Airborne fraudulently induced Squid Soap to enter into the APA by fraudulent representations in the APA and by misrepresentations outside of the APA.[270] With respect to representations made in the APA, the court concluded that the only representation made by Airborne with respect to litigation did not support Squid Soap's contract-based fraud claim.[271]

Fraud Based on Extra-Contractual Misrepresentations

With respect to Squid Soap's fraud claim based on extra-contractual misrepresentations, the court first considered whether the APA contained an anti-reliance provision that would preclude such a claim.[272] The court emphasized that under Delaware law, an anti-reliance provision must clearly state that there was no reliance on statements outside the contract's four corners in the parties' decision to enter into the contract.[273] The court characterized the provision of the APA that Airborne contended was an anti-reliance provision as a "standard integration clause, albeit a wordy one," which did not contain the necessary anti-reliance language.[274] The court therefore considered Squid Soap's allegations of extra-contractual fraud, but found them to be generalized and non-specific, and insufficient to meet the requirement that the circumstances constituting fraud be stated with particularity.[275]

Equitable Fraud

With respect to Squid Soap's claims for equitable fraud, the court was of the view that "[t]his case does not involve a special circumstance that would merit exercising this Court's equitable power to go beyond the traditional framework of common law fraud."[276]

268. *Id.* at 136.
269. *Id.*
270. *Id.*
271. That representation reads as follows: "[T]here are no Legal Proceedings pending, or to the Knowledge of Purchaser, threatened that are reasonably likely to prohibit or restrain the ability of Purchaser to enter into this Agreement or consummate the transactions contemplated hereby." *Id.* at 137. The court compared that representation with the much broader litigation representation required of Squid Soap, pointing out that Squid Soap could have required such a representation of Airborne. *Id.* at 140–43.
272. *Id.* at 140.
273. *Id.* at 140–41.
274. *Id.* at 141.
275. *Id.* at 142–43.
276. *Id.* at 144.

Implied Duty of Good Faith and Fair Dealing

Squid Soap attempted to invoke the obligation of good faith and fair dealing to argue both that Airborne had an affirmative obligation to disclose the California state court litigation and that Airborne was obliged to spend funds on marketing and to achieve sales.[277] As to the litigation, the court referred to the specific language of Airborne's litigation representation, pointed out that Squid Soap could have insisted on a broader representation, and stated that "the implied covenant is not a means to re-write agreements."[278] But the court thought that the arguments regarding spending funds "have a tinge more color."[279] The court stated:

> The provision Squid Soap seeks to imply is that Airborne could not arbitrarily refuse to expend resources and thereby deprive Squid Soap of the prospects for the earn-out. . . . There is support in our law for this argument. When a contract confers discretion on one party, the implied covenant requires that the discretion be used reasonably and in good faith.[280]

This claim failed, however, because Squid Soap's counterclaim alleged not that Airborne acted in bad faith or arbitrarily, but that "Airborne suffered a corporate crisis in its core business and, at least in part as a result of that crisis, did not expend resources on Squid Soap."[281]

Revised Claims for Extra-Contractual Fraud

After the court's decision in *Airborne No. 1*, Squid Soap moved to modify the judgment, and alleged numerous representations regarding Airborne's brand name, marketing expertise and resources, and relationships with retailers that Squid Soap claims were made at various meetings and presentations, in a letter of intent prepared by Weil, and in telephone conversations.[282] It further alleged that in reliance on these representations, it decided to enter into a deal with Airborne rather than another suitor.[283]

The court held that "the allegations do not plead a claim for fraud,"[284] based on the following conclusions:

(1) To the extent that the claim relied on affirmative falsehoods, it failed because Airborne did not make a false representation of material fact, i.e., did not deny that it faced litigation or make any more general statement about the type of litigation that it faced.[285]

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277. *Id.* at 146.
278. *Id.*
279. *Id.*
280. *Id.* at 146–47.
281. *Id.* at 147.
282. Airborne Health, Inc. v. Squid Soap, L.P., No. 4410-VCL, 2010 WL 2836391, at *1–4 (Del. Ch. July 20, 2010).
283. *Id.* at *5.
284. *Id.* at *7.
285. *Id.*

(2) The statements that Airborne made were puffery, i.e., "vague statements of corporate optimism designed to boost the appeal of Airborne as a potential transaction partner for Squid Soap."[286]

(3) To the extent the claim was for fraud based on active concealment, the court concluded that Squid Soap had not alleged facts supporting a plausible inference that Airborne actively concealed information about pending litigation, going on to point out that the California litigation was a matter of public record, discoverable through a litigation search or by asking Airborne (Squid Soap did not allege that it asked), and that "Squid Soap explored strategic alternatives with the assistance of a well-known and sophisticated law firm."[287] The court said:

> Parties engaging in M & A activity with the assistance of AmLaw 100 law firms ask questions. [Such firms] have lengthy, itemized questionnaires called due diligence checklists . . . . If Squid Soap had asked about litigation and was not told about the California Action or the regulatory proceedings, then Airborne would have a problem. . . . If Airborne had made a misleading partial disclosure or offered a half-truth designed to put Squid Soap off the scent, then the motion to dismiss would be denied."[288]

(4) Airborne had no "duty to speak," as an "arms' length counter-party negotiating across the table from Squid Soap."[289]

(5) Airborne's litigation representation in the APA was not a partial disclosure giving rise to a duty to speak, and was accurate."[290]

Conclusion

The court's opinions are strong reminders of some of the risks that are inherent in earn-out transactions, particularly when the potential earn-out is a significant part of the consideration. As the court noted, an earn-out "often converts today's disagreement over price into tomorrow's litigation over the outcome."[291] The litigation representation required of Airborne by Squid was a conventional form of buyer's litigation representation for a transaction in which the seller is receiving cash, as all or most of the consideration, at closing. But in an earn-out transaction involving significant deferred contingent consideration, the situation may be analogous to a transaction in which the seller is receiving stock or a note, and thus one calling for expanded representations from the buyer and perhaps expanded seller due diligence.

286. *Id.* at *8.
287. *Id.* at *8–9.
288. *Id.* at *9.
289. *Id.*
290. *Id.* at *10.
291. Airborne Health, Inc. v. Squid Soap, L.P., 984 A.2d 126, 132 (Del. Ch. 2009).

Fraudulent Conveyance

12. Boyer v. Crown Stock Distribution, Inc. (Corporate Transfer Is Fraudulent If Buyer Does Not Receive Reasonably Equivalent Value, Allowing Chapter 7 Trustee of Buyer to Recover for Prior Purchase)

Boyer v. Crown Stock Distribution, Inc.[292] involved claims by a Chapter 7 trustee of the buyer in an asset acquisition, roughly 3.5 years after the closing of the acquisition, to recover amounts distributed to the shareholders of the seller in connection with the acquisition. The trustee asserted that the price exceeded what the business was worth and the sale was a "fraudulent conveyance in violation of Ind. Code § 32-18-2-14(2) (section 4(a)(2) of the Uniform Fraudulent Transfer Act [("UFTA")])."[293]

In January 1999, Crown Unlimited Machine, Inc. ("Old Crown") and its shareholders agreed to sell all of Old Crown's assets to Kevin Smith, for $6 million.[294] On closing, Old Crown received $3.1 million in cash ("Cash Payment") and a $2.9 million promissory note ("Old Crown Note") from a new corporation formed by Smith ("New Crown"), which bore the same name as Old Crown.[295] The cash payment was borrowed from a bank, and the loan was secured by all of the assets of New Crown.[296] The note bore interest of 8 percent, but the agreement of sale limited New Crown's payments on the note to $100,000 per year unless New Crown's sales exceeded a "specified high threshold."[297] The Old Crown Note was secured, but Old Crown's security interest was subordinated to the bank's.[298] Smith contributed only $500 of his own money toward the purchase.[299] Just before the closing, Old Crown transferred $590,328 from its corporate bank account to a separate account and then to its shareholders (the "Dividend").[300]

The court stated:

> [New Crown] declared bankruptcy in July 2003, and its assets were sold pursuant to 11 U.S.C. § 363 . . . for $3.7 million. The buyer was a new company of which Smith is now the president. Most of the money realized [went to pay off] the bank; very little was left over to pay the claims of [N]ew Crown's unsecured creditors, who were owed some $1.6 or $1.7 million and on whose behalf the trustee in bankruptcy brought the adversary action.[301]

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292. 587 F.3d 787 (7th Cir. 2009).
293. *Id.* at 790.
294. *Id.*
295. *Id.*
296. *Id.*
297. *Id.*
298. *Id.*
299. *Id.*
300. *Id.*
301. *Id.* at 791.

Judge Posner noted that the action was timely as coming within the four-year "look back" period of the UFTA and within the periods specified in the Bankruptcy Code.[302]

Bankruptcy Court

The bankruptcy judge ruled that the Cash Payment plus the Old Crown Note, aggregating $6 million, had been paid "without [New Crown] receiving a reasonably equivalent value in exchange," and that as a result New Crown had embarked on "a business . . . for which [its] remaining assets . . . were 'unreasonably small in relation to the business.'"[303] The bankruptcy judge thought that $4 million was the highest value that could be assigned to the business of Old Crown.[304] Accordingly, he held that Old Crown and its shareholders could not enforce the Old Crown Note and could not keep the Cash Payment or the two $100,000 interest payments that New Crown had made on the Old Crown Note (the only payments ever made on that note).[305]

The bankruptcy judge held, however, that the Dividend was legitimate because it had been paid out of cash belonging to Old Crown.[306]

The bankruptcy judge's opinion was affirmed by the district court and appeals were taken to the U.S. Court of Appeals for the Seventh Circuit.[307]

Appeals Court

Fraudulent Conveyance. Judge Posner began his analysis by pointing out that in a conventional LBO, an investor buys the stock of the target with the proceeds of a loan secured by the target's assets.[308] A transaction is "fraudulent" within the meaning of the UFTA (even if there is no fraudulent intent) "if the corporation didn't receive 'reasonably equivalent value' . . . and as a result was left with insufficient assets to have a reasonable chance of surviving indefinitely."[309] Judge Posner points out that some courts have been reluctant to apply the UFTA to LBOs, because minority shareholders have no power to prevent the deal, and because many LBOs (where the company is publicly held and managers have a relatively low equity stake) have the beneficial effect of making the managers owners and thus fusing management with control.[310] But in this case, the shareholders were apparently all members of one family, and Old Crown was not publicly held.[311] And, the opinion states, "this LBO was *highly* likely to plunge the company into bankruptcy."[312]

302. *Id.*
303. *Id.* (alterations in original).
304. *Id.*
305. *Id.*
306. *Id.*
307. *Id.* at 790.
308. *Id.* at 791–92.
309. *Id.* at 792.
310. *Id.*
311. *Id.* at 792–93.
312. *Id.* at 793.

Acquisition Structure. The court rejected the argument that the acquisition had been structured as an asset acquisition, rather than as an acquisition of stock:

> The purchase was nominally of the assets of [O]ld Crown but actually of the ownership of the company; for [O]ld Crown distributed money it received in the sale . . . and from then on existed only as a shell. New Crown operated under the same name as its predecessor, and its trade creditors and other unsecured creditors were not even told about the transaction.[313]

Passage of Time Since Closing. The court also rejected the argument that New Crown did not declare bankruptcy until 2003 and might have avoided it if not for mistakes Smith made in running the company.[314] The amount of intervening time was "pertinent evidence."[315] Critical to the court's analysis, however, was that New Crown from the outset had insufficient capital and no collateral to offer to lenders, since all of its assets were encumbered for both the Cash Payment and the Old Crown Note, and that the Dividend had depleted the working cash of the business being sold.[316]

The court reversed the bankruptcy judge's conclusions with respect to the Dividend, concluding that it was "an integral part of the LBO," as family corporations rarely pay dividends, at least four of the shareholders were officers or directors and presumably salaried, the Dividend represented 50 percent of Old Crown's 1999 profits, an unreasonably high dividend given the cash needs of the business, and the Dividend drained the business of cash unbeknownst to the corporation's past and future unsecured creditors, so that the defendants had the burden (which they did not carry) of producing evidence that the Dividend was a bona fide dividend.[317]

The defendants argued that the Old Crown Note was really worth very little from the outset, because there was no reasonable expectation that it would be paid, and that therefore they were really selling the company for only the Cash Payment, "and it was worth that much."[318] Judge Posner rejected that argument summarily: "This is virtually a confession that the purpose of the [Old Crown Note] was to make sure that the unsecured creditors would never be able to get at the corporation's assets in the event of bankruptcy."[319]

Protection of Second Stage Transferees. The court also needed to address issues relating to the restoration to New Crown of the money it had paid for the assets.[320] This involved issues under section 550(b)(2) of the Bankruptcy Code. In sum, the court concluded that because the transaction was "collapsed" in an LBO analysis,

313. *Id*. at 793–94.
314. *Id*. at 794.
315. *Id*. at 795.
316. *Id*. at 794.
317. *Id*. at 795–96.
318. *Id*. at 796.
319. *Id*.
320. *Id*.

the shareholders are initial, not subsequent, transferees and do not get the protection of that section.[321]

Windfall Argument. In addition, the court had to deal with the defendants' argument that even if their receipt of the Dividend and the Cash Payment was voidable, they should not have to return any of it because that would give the trustee a windfall.[322] The assets were sold in the section 363 transaction for $3.7 million.[323] Thus, the defendants argued, if Old Crown gets no credit for the initial transfer, the debtor's estate will have received the amount of the judgment ($3.295 million), plus the Dividend (almost $600,000), plus the proceeds of the section 363 sale ($3.7 million), aggregating in excess of $7.6 million, all to pay (besides administrative expenses) total debts of only $5.2 million or $5.3 million.[324]

The opinion states:

> Although the debtor is [N]ew Crown rather than [O]ld Crown, the fact that the debtor receives any surplus . . . doesn't mean that the money stays there. It can't stay there for long, since the estate is dissolved at the conclusion of the bankruptcy proceeding. . . . [S]hould all the unsecured creditors of [N]ew Crown be paid in full the only other potential claimants to any surplus money in its estate will be the original shareholders. The LBO was fraudulent only with respect to the unsecured creditors. If and when they are paid in full, the wrong committed by the shareholders will have been righted and there will be no reason to deny their claims to whatever money is left over.[325]

Conclusion

Judge Posner's opinion in *Boyer* is a useful reminder that fraudulent conveyance issues can arise not only from underpayment for the seller's business, but also from overpayment that leaves a buyer of the seller's assets with insufficient capital to carry on the business.

Fraudulent and Negligent Misrepresentation

13. GA Escrow, LLC v. Autonomy Corp. PLC (Shareholder Representative's Claim for Misrepresentation Arising from Acquiror's Indemnity Claim Notice Under Merger Agreement Survives Motion for Summary Judgment)

In *GA Escrow, LLC v. Autonomy Corp. PLC*,[326] the U.S. District Court for the Northern District of California denied an acquiror's motion for summary judgment on a target shareholder representative's misrepresentation claim because the shareholder representative's belief that representations made by publicly traded companies represented by prominent law firms are generally truthful created an

321. *Id.*
322. *Id.* at 797.
323. *Id.*
324. *Id.*
325. *Id.*
326. No. C 08-01784 SI, 2010 WL 2724461 (N.D. Cal. July 8, 2010).

issue of disputed fact as to whether the shareholder representative justifiably relied on representations made by the acquiror in an indemnity claim notice under a merger agreement.

In 2007, the defendant Autonomy Corp. PLC ("Autonomy") acquired Zantaz, Inc., a software company, for approximately $400 million in a merger.[327] General Atlantic ("GA") was Zantaz's largest shareholder prior to the acquisition.[328] The plaintiff GA Escrow, LLC ("GA Escrow") was a special purpose entity formed by GA to serve as the shareholder representative of the former Zantaz shareholders.[329] Under the merger and escrow agreements, Autonomy deposited $20.5 million of the purchase price into an escrow account to satisfy potential indemnity claims.[330]

If Autonomy had an indemnity claim under the merger agreement, it was required to submit a notice of the claim to GA Escrow and to the escrow agent.[331] If the escrow agent received an objection from GA Escrow within the following ten business days, it was required to hold the disputed funds pending resolution of the dispute.[332] If, however, GA Escrow failed to object to the claim within ten business days, the losses specified in Autonomy's notice of claim were deemed to be conclusively established, and the escrow agent was required to distribute the requested amount to Autonomy.[333]

Autonomy sent GA Escrow and the escrow agent a notice of claim for approximately $8 million in losses based on alleged misrepresentations by Zantaz concerning its financial statements.[334] GA Escrow did not object to Autonomy's claim within the ten business day period, and the escrow agent released the requested funds from the escrow account to Autonomy.[335] GA Escrow thereafter objected to Autonomy's claims and sought further details regarding the basis for the claims.[336] When the parties were unable to resolve their dispute, GA Escrow filed suit against Autonomy alleging claims for fraudulent misrepresentation, negligent misrepresentation, and breach of the covenant of good faith and fair dealing.[337] GA Escrow also sought an accounting of Autonomy's losses.[338] The court denied Autonomy's motion for summary judgment on all of GA Escrow's claims.[339]

Autonomy moved for summary judgment on GA Escrow's misrepresentation claim on the grounds that GA Escrow could not have justifiably relied on any false representations made by Autonomy in its notice of claim.[340] Autonomy also

327. *Id.* at *1.
328. *Id.*
329. *Id.*
330. *Id.*
331. *Id.*
332. *Id.*
333. *Id.* at *1, *5.
334. *Id.* at *1.
335. *Id.* at *2.
336. *Id.*
337. *Id.*
338. *Id.*
339. *Id.* at *6.
340. *Id.* at *3.

maintained that GA Escrow's misrepresentation claims were barred by California's litigation privilege.[341]

Reliance

With respect to actual reliance, the court determined that GA Escrow had provided sufficient evidence that it had actually relied on the representations made by Autonomy in the notice of claim.[342] The managing director and general counsel of GA testified that had he known that Autonomy's claims were not based in fact, he would not have relied on the notice and would have objected to the claims immediately.[343]

With respect to justifiable reliance, the court noted that the test under California law was "whether the person who claims reliance was justified in believing the representation in light of his own knowledge and experience."[344] The court determined that GA Escrow had justifiably relied on the representations made by Autonomy in the notice of claim because GA Escrow persuasively argued "that its knowledge and experience have led it to believe that representations made by a large, publicly traded company working with a reputable and prominent law firm will generally be truthful and have an adequate factual basis."[345]

Litigation Privilege

Autonomy also moved for summary judgment on GA Escrow's misrepresentation claims on the grounds that they were barred by California's litigation privilege.[346] The litigation privilege bars tort claims (other than malicious prosecution) arising from communications made in connection with litigation proceedings, including pre-litigation communications.[347] Autonomy argued that its notice of claim amounted to a pre-litigation demand letter and was therefore subject to the protection of the litigation privilege.[348] The court disagreed with Autonomy's argument and concluded that the litigation privilege does not apply to communications made prior to litigation unless the threat of litigation was imminent at the time the communication was made.[349]

Implied Covenant of Good Faith and Fair Dealing

GA Escrow also alleged that Autonomy breached the implied covenant of good faith and fair dealing by knowingly and falsely making claims for losses without

341. *Id.* at *3–4.
342. *Id.* at *3.
343. *Id.*
344. *Id.* (quoting Gray v. Don Miller & Assocs., Inc., 674 P.2d 253, 255 (Cal. 1984)).
345. *Id.*
346. *Id.* at *4.
347. *Id.*
348. *Id.*
349. *Id.*

having any reasonable basis in fact.[350] Autonomy moved for summary judgment on GA Escrow's good faith and fair dealing claim on the grounds that the escrow agreement expressly provided that if GA Escrow failed to object to a claim within ten business days, the factual basis for the losses claimed by Autonomy were deemed to be conclusively established.[351] Autonomy argued that GA Escrow could not use the implied covenant of good faith and fair dealing to circumvent the express terms of the merger agreement.[352]

The court rejected Autonomy's argument, concluding that a misrepresentation going to the existence of any factual basis for an indemnity claim unfairly frustrated GA Escrow's ability to enjoy the benefits of the contract.[353] The court determined that GA Escrow presented evidence "that the very nature of the parties' relationship contemplated that [Autonomy] would not submit baseless claims."[354]

Autonomy did not independently challenge GA Escrow's accounting claim but argued that the accounting claim must fail because Autonomy was entitled to summary judgment on all other claims.[355] Because the court denied summary judgment as to GA Escrow's misrepresentation and breach of good faith and fair dealing claims, it also denied summary judgment as to GA Escrow's accounting claim.[356]

Conclusion

While the holding is limited to the specific facts, the court's denial of summary judgment on the grounds that an apparently sophisticated commercial party in a $400 million merger transaction may be justified, without any investigation, in relying on the representations of an adverse party in an indemnity claim notice is a somewhat surprising result.

350. *Id.* at *5.
351. *Id.*
352. *Id.*
353. *Id.*
354. *Id.*
355. *Id.*
356. *Id.* at *6.

Introduction to the 2011 Annual Survey of Consumer Financial Services Law

*By Therese G. Franzén and Alvin C. Harrell**

In 2010 the financial landscape continued to be dominated by economic and credit-related problems that began roughly in 2007 and gained widespread attention beginning in 2008.[1] These problems were characterized by a continuing contraction in private credit that both implicates and affects the consumer financial services laws that are the subjects of the *Annual Survey*.[2] In addition to the other

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* Therese G. Franzén is a partner at Franzén and Salzano in Atlanta, Georgia, and Chair of the Consumer Financial Services Committee of the American Bar Association Section of Business Law. Alvin C. Harrell is Professor of Law at the Oklahoma City University School of Law and Editor of the Annual Survey of Consumer Financial Services Law.

1. *See, e.g.*, Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2009 Annual Survey of Consumer Financial Services Law*, 64 Bus. Law. 465 (2009); Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2008 Annual Survey of Consumer Financial Services Law*, 63 Bus. Law. 561 (2008); Alvin C. Harrell, Commentary, *The Subprime Lending Crisis—The Perfect Credit Storm?*, 61 Consumer Fin. L.Q. Rep. 626 (2007).

2. *See, e.g.*, Conor Dougherty & Luca Di Leo, *Loan Standards Ease, but Crunch Isn't Over*, Wall St. J., Nov. 9, 2010, at A6; Andrew J. Johnson, *Fed Talk Puts Pressure on Dollar*, Wall St. J., Oct. 2, 2010, at B16 (quoting senior Federal Reserve Board ("FRB") officials as stating that "[t]he current situation is wholly unsatisfactory" and may indicate that the United States is in a "liquidity trap").

The latter is an apparent reference to the observation commonly attributed to famed economist John Maynard Keynes, essentially to the effect that, at some point, an ineffective FRB monetary policy is like "pushing on a string." In fact, the source may be elsewhere. According to some sources, the phrase "you cannot push on a string" originated with Congressman T. Alan Goldsborough (addressing Federal Reserve Board Chairman Marrimer Eccles during hearings on the Banking Act of 1935). *See, e.g.*, George Melloan, Opinion, *We're All Keynesians Again*, Wall St. J., Jan. 13, 2009, at A17; Roger G. Sandilans, *The New Deal and 'Domesticated Keynesianism ' in America, in* Economist with a Public Purpose: Essays in Honour of John Kenneth Galbraith 219, 231 (Michael Keaney ed., 2001); John H. Wood, A History of Central Banking in Great Britain and the United States 231 (2005) (citing *Banking Act of 1935: Hearing Before the H. Banking Currency Comm.*, 74th Cong. 337 (1935)).

It is also possible that the phrase may already have been "proverbial" when Goldsborough used it. *See*, *e.g.*, *Pushing on a String*, Wikipedia, http://en.wikipedia.org/wiki/Pushing_on_a_string (last visited Nov. 20, 2010). We are aware of the limitations of a Wikipedia citation, but believe that it is appropriate in this instance. *See*, *e.g.*, Lee F. Peoples, *The Lawyer's Guide to Using and Citing Wikipedia*, 81 Okla. B. Ass'n J. 2437 (2010).

In any event, the phrase "pushing on a string" and the dangers of a liquidity trap have long been textbook economics. *See*, *e.g.*, James D. Gwartney, Economics: Private and Public Choice 222, 225–26 (1976); *see also* Sewell Chan, *Fed Is Expected to Discuss More Ways to Revive Economy*, N.Y. Times, Sept. 20, 2010, at B3 (quoting a senior FRB official on the adverse effects of "uncertainty over taxes and regulation" and also citing the analogy to "pushing on a string"); Charles R. Schwab, Opinion, *Enough with Low Interest Rates!*, Wall St. J., Oct. 2, 2010, at A15 ("As of August [2010], we'd seen our fourth straight month of contraction [in consumer spending]. Revolving credit-card debt shrank to $7.4 billion, continuing a 20-month stretch of declines.").

significant developments affecting consumer financial services law, this year's *Annual Survey* describes the most significant restructuring of federal consumer credit law and regulation in memory.[3] These developments are likely to affect the state of the consumer finance industry and, perhaps, the availability of consumer credit for years to come.[4] While the precise impact cannot be predicted with any degree of certainty, it is clear that the developments described in this year's *Annual Survey* are in many ways unprecedented and likely to have significant long-term effects on both consumers and their financial services providers.[5]

Even before enactment of the Dodd-Frank Act,[6] the FRB had been very active in recent years in revising Regulation Z.[7] That pace seems to be quickening in advance of the "designated transfer date" for turnover of many FRB consumer credit regulatory functions to the new Bureau of Consumer Financial Protection ("CFPB").[8] Moreover, as described in this year's *Annual Survey*, much the same can be said for other federal regulations, e.g., those affecting the origination of consumer mortgage loans.[9] As a result, consumer financial service providers and their customers are in the midst of a rapidly changing legal environment, with even more changes expected after the designated transfer date to the CFPB.[10] These legal and regulatory developments, the related decline in private credit availability and housing values, and a continuing high level of mortgage foreclosures in many areas of the country have left consumer borrowers with an unprecedented reliance on federal sources of mortgage credit.[11]

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3. Various authors in this *Annual Survey* discuss the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]. Almost certainly this is the single most significant change in consumer financial services law since the federal Consumer Credit Protection Act of 1968, which included the Truth in Lending Act, arguably the first major federal entry into the direct regulation of consumer credit.

4. *See, e.g.*, Alvin C. Harrell, Commentary, *The Perils of Public Finance*, 64 Consumer Fin. L.Q. Rep. 253 (2010); *see generally* Kathleen E. Keest, *Consumer Financial Services Law and Policy: 1968–20?? In the Thick of the Battlefield for America's Economic Soul*, 26 Ga. St. U. L. Rev. 1087 (2010); Alvin C. Harrell, *The Great Credit Contraction: Who, What, When, Where and Why*, 26 Ga. St. U. L. Rev. 1209 (2010).

5. *See, e.g.*, sources cited at *supra* note 4.

6. *See supra* note 3.

7. 12 C.F.R. pt. 226 (2010). For a discussion of these developments, see Catherine M. Brennan, Jeffrey P. Naimon & Jacqueline A. Parker, *Truth in Lending Update—2010*, 66 Bus. Law. 413 (2011) (in this *Annual Survey*).

8. The designated transfer date is July 21, 2011. *See* Bureau of Consumer Financial Protection, Designated Transfer Date, 75 Fed. Reg. 57252, 57252 (Sept. 20, 2010). This is the date for transfer of most of the FRB's consumer credit regulatory authority to the CFPB. *Id.*

9. *See e.g.*, John P. Kromer, Sanford Shatz & Jonathan W. Cannon, *2010 Survey of RESPA Developments*, 66 Bus. Law. 435 (2011) (in this *Annual Survey*); John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, *Fair Lending Developments: Enforcement Comes to the Fore*, 66 Bus. Law. 447 (2011) (in this *Annual Survey*). Probably no area of consumer credit law is more heavily impacted than subprime mortgage lending. *See, e.g.*, Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett & Arthur B. Axelson, *Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act*, 66 Bus. Law. 457 (2011) (in this *Annual Survey*); Robert A. Cook & Meghan Musselman, *Summary of the Mortgage Lending Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 64 Consumer Fin. L.Q. Rep. 231 (2010).

10. *See supra* notes 8–9 and accompanying text.

11. *See, e.g.*, Harrell, *The Great Credit Contraction, supra* note 4, at 1209–13 & nn.2–9; Harrell, *The Perils of Public Finance*, *supra* note 4, at 1209, 1234–37, 1239, 1244–46 & 1257–58.

These changes and recent litigation have also affected post-origination activities, including credit reporting,[12] loan servicing,[13] arbitration,[14] debt collection,[15] and mortgage foreclosure.[16] Merchants engaged solely in the sale, servicing, or leasing of nonfinancial goods or services (including motor vehicles) are excluded from CFPB jurisdiction (though not all CFPB rules and regulations) if they sell only delinquent debt to third parties.[17] Motor vehicle dealers may have been spared much of the public policy whirlwind surrounding the passage of Dodd-Frank,[18] but, as noted in this *Annual Survey*, they have not avoided litigation controversies of their own.[19] And of course, credit cards have been the subject of active attention by Congress and federal regulators for several years now, as again reported in this year's *Annual Survey*.[20]

As noted in last year's *Introduction*, the relationships between state and federal laws and regulations (and the future of longstanding principles of federalism) are at the forefront of the public policy debates over consumer law.[21] In addressing these issues, the Dodd-Frank Act has significantly changed the legal landscape for many parties and transactions, and at the same time provides the potential for other consequences that are not predictable at this time.[22] Related developments noted in this year's *Annual Survey* also include the relation between state and federal laws illustrated in the recent litigation over home mortgage foreclosures and loan modifications.[23] While the impact of the Dodd-Frank Act on payment system

12. *See, e.g.*, Andrew M. Smith & Peter Gilbert, *Fair Credit Reporting Act Update—2010*, 66 Bus. Law. 473 (2011) (in this *Annual Survey*).

13. *See, e.g.*, sources cited at *supra* note 9. Not to mention privacy. *See*, *e.g.*, Patricia E.M. Covington & Meghan Musselman, *2010 Privacy and Data Security Developments*, 66 Bus. Law. 483 (2011) (in this *Annual Survey*).

14. *See, e.g.*, Alan S. Kaplinsky, Mark J. Levin & Martin C. Bryce, Jr., *Arbitration Developments: Has the Supreme Court Finally Stepped In?*, 66 Bus. Law. 529 (2011) (in this *Annual Survey*).

15. *See, e.g.*, Laurie A. Lucas, Tomio B. Narita & Anna-Katrina S. Christakis, *Recent Cases Concerning the Treatment of Attorney Debt Collectors Under the FDCPA*, 66 Bus. Law. 551 (2011) (in this *Annual Survey*).

16. *See*, *e.g.*, Ruth Simon, Robin Sidel & Nick Timiraos, *Mortgage Lenders Set Back in Courts*, Wall St. J., Nov. 10, 2010, at A1; Nick Timaraos, Jessica Silver-Greenberg & Dan Fitzpatrick, *Mortgage Damage Spreads*, Wall St. J., Oct. 16, 2010, at A1; Richard E. Gottlieb & Brett J. Natarelli, *Update on Loan Modification Litigation*, 66 Bus. Law. 539 (2011) (in this *Annual Survey*).

17. *See* Dodd-Frank Act, *supra* note 3, §§ 1027, 1029, 124 Stat. at 1995–2003, 2004–05 (to be codified at 12 U.S.C. §§ 5517, 5519); Caggiano, Dozier, Hackett & Axelson, *supra* note 9, at 460–461 & nn. 25–38.

18. *See, e.g.*, sources cited at *supra* notes 1, 4 & 9.

19. *See* David E. Gemperle & Kenneth J. Rojc, *Auto Finance: Litigation and Legislative Developments Impacting Supplemental Products*, 66 Bus. Law. 495 (2011) (in this *Annual Survey*).

20. *See* Obrea O. Poindexter, *Update on CARD Act Rules—Credit Cards*, 66 Bus. Law. 423 (2011) (in this *Annual Survey*).

21. *See* Therese G. Franzén & Donald C. Lampe, *Introduction to Annual Survey of Consumer Financial Services Law*, 65 Bus. Law. 521, 521 (2010).

22. *See, e.g.*, Ralph T. Wutscher & David L. Beam, *The Dodd-Frank Act's New Federalism*, 66 Bus. Law. 519 (2011) (in this *Annual Survey*); Matthew Dyckman, Matthew S. Yoon & John P. Holahan, *Financial Regulatory Reform—The Dodd-Frank Act Rolls Back Federal Preemption*, 64 Consumer Fin. L.Q. Rep. 129 (2010) (the elimination of "field preemption" is "a 'game changer' for federal thrifts").

23. *See* Gottlieb & Natarelli, *supra* note 16, at 543–550.

issues may seem modest in comparison, new ground continues to be broken there as well.[24]

It remains to be seen whether the policy initiatives and legal developments noted here and described at further length throughout this *Annual Survey* represent an optimal solution to the current credit problems affecting consumers and the economy.[25] In some instances, these initiatives are directed at preventing another credit "bubble," by adding substantive consumer restrictions that may constrain the availability of consumer credit.[26] While some may view this as an overriding policy goal, it is not clear that this is the best time to pursue such a goal, given that the current problems appear to be the result of a continuing contraction rather than a credit expansion.[27] When even the FRB is said to be "pushing on a string,"[28] perhaps it is time to reconsider the impact of our approach to the regulation of consumer financial services transactions on our nation's economy.[29]

24. *See*, *e.g.*, Ryan S. Stinneford, Laura Hobson Brown & Candace Modlin Davis, *Current Developments in Bank Deposits and Payment Systems*, 66 Bus. Law. 507 (2011) (in this *Annual Survey*).

25. *See, e.g.*, sources cited at *supra* notes 1, 2 & 4.

26. *See, e.g.*, *id.*

27. *See supra* note 4.

28. *See supra* note 2.

29. *See*, *e.g.*, Lampe, Miller & Harrell, *Introduction to the 2009 Annual Survey of Consumer Financial Services Law*, *supra* note 1, at 465–67.

Truth in Lending Update—2010

*By Catherine M. Brennan, Jeffrey P. Naimon, and Jacqueline A. Parker**

Introduction

There were numerous amendments, proposed amendments, and interesting issues concerning the Truth in Lending Act ("TILA")[1] and Federal Reserve Board ("FRB") Regulation Z[2] over the past year. Additional proposed amendments and final rules will be issued to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act.[3] The most significant statutory changes to TILA are discussed elsewhere in this *Annual Survey*,[4] where it is also detailed how the Dodd-Frank Act requires the FRB (to be succeeded in this respect by the new Bureau of Consumer Financial Protection) to issue numerous rulemakings.[5] On a parallel path, the FRB continued to issue rulemakings stemming from its comprehensive review of Regulation Z. The latter changes, and recent TILA litigation, are discussed below.

Amendments to Regulation Z

Card Act

The FRB implemented a significant number of TILA amendments in 2010. In addition to the changes discussed below, the FRB issued two final rules to implement

* Catherine M. Brennan is a partner in the Maryland Office of Hudson Cook, LLP. Jeffrey P. Naimon is a partner in the Washington, D.C. office of BuckleySandler LLP. Jacqueline A. Parker is Vice President & Senior Counsel of TD Bank, N.A. Ms. Brennan and Mr. Naimon are the Co-Chairs and Ms. Parker is the immediate past Chair of the Truth in Lending Subcommittee of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law.

1. Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (codified as amended at 15 U.S.C.A. §§ 1601–1667f (West 2009 & Supp. 2010)).
2. Regulation Z, 12 C.F.R. pt. 226 (2010).
3. Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]. For additional material on the Dodd-Frank Act, see Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett & Arthur B. Axelson, *Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act*, 66 Bus. Law. 457 (2011) (in this *Annual Survey*); Andrew M. Smith & Peter Gilbert, *Fair Credit Reporting Act Update—2010*, 66 Bus. Law. 473 (2011) (in this *Annual Survey*); and Ralph T. Wutscher & David L. Beam, *The Dodd-Frank Act's New Federalism*, 66 Bus. Law. 519 (2011) (in this *Annual Survey*). *See also* Matthew Dyckman, Matthew S. Yoon & John P. Holahan, *Financial Regulatory Reform—The Dodd-Frank Act Rolls Back Federal Preemption*, 64 Consumer Fin. L.Q. Rep. 129 (2010); Robert A. Cook & Meghan Musselman, *Summary of the Mortgage Lending Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 64 Consumer Fin. L.Q. Rep. 231 (2010).
4. *See supra* note 3.
5. *See id.*

provisions of the Credit Card Accountability Responsibility and Disclosure Act of 2009[6] that were effective February 22, 2010, and August 22, 2010.[7]

Final Rule on Loan Originator Compensation Practices

The FRB issued its final rule amending Regulation Z to protect mortgage borrowers from unfair, abusive, and deceptive lending practices that can arise from loan originator compensation practices.[8] The FRB issued its proposed rule under the authority granted it pursuant to the Home Ownership and Equity Protection Act of 1994 ("HOEPA")[9] to prohibit unfair and deceptive acts and practices in connection with mortgages.[10] The final rule applies to mortgage brokers and the companies that employ them, as well as mortgage loan officers employed by depository institutions and other lenders.[11] The final rule bans compensation to a loan originator—which includes mortgage brokers and loan officers—based on the interest rate or other loan terms.[12] "Loan originator" means "a person who for compensation or other monetary gain, or in expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person . . . includ[ing] an employee of the creditor . . . [and] a creditor [who] does not provide the funds for the transaction at consummation out of the creditor's own resources."[13] A mortgage broker is simply "any loan originator that is not an employee of the creditor."[14] This ban will prevent loan originators from increasing their own compensation by basing it on the consumers' "transaction terms or conditions," such as by increasing the interest

6. Pub. L. No. 111-24, 123 Stat. 1734 (to be codified in scattered sections of 15 U.S.C.) [hereinafter CARD Act].

7. *See* Truth in Lending, 75 Fed. Reg. 7658, 7658 (Feb. 22, 2010) (to be codified at 12 C.F.R. pt. 226) [hereinafter February 2010 Rule]; Truth in Lending, 75 Fed. Reg. 37526, 37526 (June 29, 2010) (to be codified at 12 C.F.R. pt. 226) [hereinafter June 2010 Rule]; *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Jan. 12, 2010), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20100112a.htm; Press Release, Bd. of Governors of the Fed. Reserve Sys. (June 15, 2010), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20100615a.htm.

The February 2010 rule amended the interim final rule issued in August 2009 and, among other things, prohibited certain practices in the first year that an account is open, provided advance notice requirements for rate increases and changes in terms, and prohibited creditors from allocating payments in ways that maximized interest charges. February 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7660–62. The rule issued in June 2010 relates to late payment and penalty fees, bans inactivity fees, and requires issuers to evaluate certain rate increases. June 2010 Rule, *supra* note 7, 75 Fed. Reg. at 37526–28. For a review of the new rules, see Obrea Poindexter, *Update on CARD Act Rules—Credit Cards*, 66 Bus. Law. 423 (2011) (in this *Annual Survey*).

8. Truth in Lending, 75 Fed. Reg. 58509, 58509 (Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226) [hereinafter Originator Compensation Final Rule].

9. Pub. L. No. 103-325, § 152(d), 108 Stat. 2160, 2191, 2194 (codified at 15 U.S.C. § 1639(*l*)(2) (2006)).

10. Truth in Lending, 74 Fed. Reg. 43232 (proposed Aug. 26, 2009) (to be codified at 12 C.F.R. pt. 226); *see also* Originator Compensation Final Rule, *supra* note 8, 75 Fed. Reg. at 58509.

11. Originator Compensation Final Rule, *supra* note 8, 75 Fed. Reg. at 58533–34 (to be codified at 12 C.F.R. § 226.36(a)).

12. *Id.* at 58534 (to be codified at 12 C.F.R. § 226.36(d)); *see also id.* at 58509.

13. *Id.* at 58534 (to be codified at 12 C.F.R. § 226.36(a)(1)).

14. *Id.* at 58535 (to be codified at 12 C.F.R. § 226.36(a)(2)).

rate or points, or by basing compensation on the inclusion of a prepayment penalty in the loan.[15] Loan originators can continue to receive compensation based on a percentage of the loan amount, as the final rule makes clear that the amount of credit extended does not constitute a transaction "term or condition," so long as the "compensation received by or paid to a loan originator, directly or indirectly, is based on a fixed percentage of the amount of credit extended."[16] The final rule thus bans yield-spread premiums, the payments mortgage brokers have historically received in exchange for guiding consumers toward higher-priced mortgage loans that have raised concerns among some consumer advocates and regulators, and have been the subject of extensive litigation.[17]

The final rule prohibits a loan originator that receives compensation directly from the consumer—which includes payments to a loan originator made out of loan proceeds—from also receiving compensation from the lender or another party.[18] The final rule seeks to ensure that consumers who agree to pay the originator directly do not also pay the originator indirectly through a higher interest rate, thereby paying more in total compensation than they realize.[19]

Additionally, the final rule prohibits loan originators from directing or "steering" a consumer to accept a mortgage loan not in the consumer's interest in order to increase the originator's compensation.[20] The prohibition on steering does not apply to home equity lines of credit or loans secured by a consumer's interest in a timeshare plan.[21] A transaction does not violate the prohibition on steering if the loan originator presents the consumer with loan options that meet certain conditions for each "type of transaction" in which the consumer expressed an interest.[22] The final rule provides that the "type of transaction" refers to fixed and adjustable rate mortgage loans as well as reverse mortgages.[23] To avoid a claim by the consumer that the loan originator steered the consumer into a loan in violation of the prohibition on steering,

> the loan originator must obtain loan options from a significant number of the creditors with which the originator regularly does business and, for each type of transaction in which the consumer expressed an interest, must present the consumer with loan options that include: (A) The loan with the lowest interest rate; [and] (B) The loan with the lowest interest rate without negative amortization, a prepayment penalty, [or] interest-only payments, [among other features].[24]

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15. *Id.* at 58536 (to be codified at 12 C.F.R. pt. 226, cmt. 226.36(d)(1)-2).
16. *Id.* at 58534 (to be codified at 12 C.F.R. § 226.36(d)(1)(ii)).
17. *See generally* Stephen F.J. Ornstein & Matthew S. Yoon, *Eleventh Circuit Decides* Culpepper v. Irwin Mortgage Corporation, 61 Consumer Fin. L.Q. Rep. 571 (2007).
18. Originator Compensation Final Rule, *supra* note 8, 75 Fed. Reg. at 58534 (to be codified at 12 C.F.R. § 226.36(d)(2)).
19. *See id.* at 58525; *see also id.* at 58536 (to be codified at 12 C.F.R. pt. 226, cmt. 226.36(d)(1)-7).
20. *Id.* at 58534 (to be codified at 12 C.F.R. § 226.36(e)).
21. *Id.* (to be codified at 12 C.F.R. § 226.36(f)).
22. *Id.* (to be codified at 12 C.F.R. § 226.36(e)(2)).
23. *Id.*
24. *Id.* (to be codified at 12 C.F.R. § 226.36(e)(3)(i)).

The loan originator must also have a good-faith belief that the consumer qualifies for the loan options presented to him or her and must highlight the loan options that reflect the lowest interest rate or the lowest interest rate with certain other features, assuming the originator presents the consumer more than three loan options.[25] The loan originator can present fewer than three loan options to the consumer so long as those loan options satisfy these criteria.[26]

The final rule does not implement the restrictions on loan originator compensation and steering by loan originators imposed by the Dodd-Frank Act.[27] The FRB indicated that it would promulgate the rule to implement new TILA section 129B(c) in the future.[28]

The final rule takes effect April 1, 2011, and applies to transactions for which the creditor receives an application on or after April 1, 2011.[29] The new Commentary to Regulation Z section 226.36 gives an example of the mandatory compliance date.[30] An application taken by a mortgage broker on March 10, 2011, and received by the creditor on March 25, 2011, need not comply with the final rule. If, however, the creditor receives the application on April 5, 2011, the transaction must comply with the final rule.[31]

Final Rules on Consumer Notification of Mortgage Loan Sales or Transfers

The FRB issued its final rule amending Regulation Z to implement the new requirement that consumers receive notice when their mortgage creditor sells or transfers their mortgage loan.[32] The new notice requirement took effect in May 2009 upon enactment of the Helping Families Save Their Homes Act, which amended TILA.[33] TILA now states:

> In addition to the other disclosures required by [TILA], not later than 30 days after the date on which a mortgage loan [defined to include any consumer credit transaction secured by the principal dwelling of a consumer] is sold or otherwise transferred or assigned to a third party, the creditor that is the new owner or assignee of the debt [must] notify the borrower in writing of such transfer, including—(A) the identity, address, [and] telephone number of the new creditor; (B) the date of transfer; (C) how to reach an agent or party having authority to act on behalf of the new creditor; (D) the location of the place where transfer of ownership of the debt is recorded; and (E) any other relevant information regarding the new creditor.[34]

25. *Id*. (to be codified at 12 C.F.R. § 226.36(e)(3)(ii), (iii)).
26. *Id*. (to be codified at 12 C.F.R. § 226.36(e)(4)).
27. Dodd-Frank Act, *supra* note 3, § 1403, 124 Stat. at 2139–41 (to be codified at 15 U.S.C. § 1639b).
28. Originator Compensation Final Rule, *supra* note 8, 75 Fed. Reg. at 58509.
29. *Id*. at 58512; *see also id*. at 58535 (to be codified at 12 C.F.R. pt. 226, cmt. 226.36-2).
30. *See id*. at 58535 (to be codified at 12 C.F.R. pt. 226, cmt. 226.36-2).
31. *Id*.
32. Regulation Z; Truth in Lending, 75 Fed. Reg. 58489, 58501–02 (Sept. 24, 2010) (to be codified at 12 C.F.R. § 226.39) [hereinafter Consumer Notification Final Rule].
33. *Id*. at 58489; *see* Helping Families Save Their Homes Act, Pub. L. No. 111-22, § 404(a), 123 Stat. 1632, 1658 (2009) (codified at 15 U.S.C.A. § 1641(g) (West Supp. 2010)).
34. 15 U.S.C.A. § 1641(g)(1).

The final rule requires the new owner or assignee, identified as a "covered person" in the final rule, to provide the notice required by the Helping Families Save Their Homes Act in writing no later than thirty days after the date of the loan's sale, transfer, or assignment.[35] A "covered person" means any natural person, organization, corporation, partnership, proprietorship, association, cooperative, estate, trust, or government unit that "becomes an owner of an existing mortgage loan by acquiring legal title to the debt obligation, whether through a purchase, assignment or other transfer, and who acquires more than one mortgage loan in any twelve-month period."[36] A "covered person" does not include a servicer of a mortgage loan where the servicer holds title "solely for the administrative convenience of the servicer in servicing the obligation."[37] The final rule generally otherwise reflects the statutory requirements of the Helping Families Save Their Homes Act.[38]

To provide compliance guidance and greater certainty on the new requirements in the Helping Families Save Their Homes Act, the FRB published interim rules in November 2009, which took effect immediately.[39] To allow "covered persons" time to make any necessary operational changes, they could continue to follow the November 2009 interim rules until the mandatory compliance date for the final rule, which was January 1, 2011.[40]

Interim Rule Revising Disclosure Requirements for Closed-End Mortgages

The FRB issued an interim rule to revise the disclosure requirements for closed-end mortgage loans under Regulation Z,[41] implementing provisions of the Mortgage Disclosure Improvement Act ("MDIA") that require lenders to disclose how borrowers' regular mortgage payments can change over time.[42]

The MDIA, which amended TILA, seeks to ensure that lenders alert mortgage borrowers to the risks of payment increases before they obtain mortgage loans with variable rates or payments in connection with closed-end transactions secured by real property or a dwelling.[43] Accordingly, under the interim rule, a creditor's cost disclosures must include a payment summary in the form of a table, stating the initial interest rate together with the corresponding monthly payment; for adjustable-rate or step-rate loans, the maximum interest rate and payment that can occur during the first five years; and a "worst case" example

35. Consumer Notification Final Rule, *supra* note 32, 75 Fed. Reg. at 58489.

36. *Id*. at 58501 (to be codified at 12 C.F.R. § 226.39(a)(1) (referencing the definition of "person" in 12 C.F.R. § 226.2(a)(22)).

37. *Id*.

38. *See id*. at 58495.

39. Truth in Lending, 74 Fed. Reg. 60143 (Nov. 20, 2009) (to be codified at 12 C.F.R. pt. 226).

40. Consumer Notification Final Rule, *supra* note 32, 75 Fed. Reg. at 58489.

41. Regulation Z; Truth in Lending, 75 Fed. Reg. 58470 (Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226) [hereinafter Disclosure Requirements Interim Rule].

42. The MDIA was enacted as part of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, 122 Stat. 2654 (2008). *See id*., tit. V, §§ 2501–2502, 122 Stat. at 2855–57 (codified at 15 U.S.C.A. §§ 1638, 1640 (West 2009)) [hereinafter MDIA].

43. *See* 15 U.S.C.A. § 1638(b)(2); *see also* Disclosure Requirements Interim Rule, *supra* note 41, 75 Fed. Reg. at 58471.

showing the maximum rate and payment possible over the life of the loan.[44] Additionally, the creditor must disclose that there is no guarantee the consumer can refinance the transaction to lower the interest rate or periodic payments.[45] The interim rule provides a model form of this "no-guarantee-to-refinance" statement that simply requires the creditor to make this disclosure: "There is no guarantee that you will be able to refinance to lower your rate and payments."[46]

The interim rule also requires lenders to disclose certain features, such as balloon payments, or options to make only minimum payments that will cause loan amounts to increase through negative amortization.[47] Creditors must comply with the interim rule for applications received on or after January 30, 2011, as specified in the MDIA.[48] Creditors have the option, however, of providing disclosures that comply with the interim rule before that date.[49] The FRB solicited comment on the interim rule for sixty days after publication in the *Federal Register* before considering the adoption of a permanent rule.[50]

FRB Proposals

Mortgage Lending Proposed Rule

On August 16, 2010, the FRB proposed several significant changes to Regulation Z.[51] As part of the FRB's comprehensive review of its mortgage lending regulations, the FRB issued its second phase of significant changes to Regulation Z for home-secured credit.[52] The proposal would simplify the rule for the consumer's right to rescind certain open-end and closed-end home-secured loans and the notice of the right to rescind that is provided to consumers at the loan closing.[53] In addition, the proposal seeks to clarify the obligations of creditors when the extended right to rescind is asserted by a consumer.[54]

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44. Disclosure Requirements Interim Rule, *supra* note 41, 75 Fed. Reg. at 58482–83 (to be codified at 12 C.F.R. § 226.18(s)).

45. *Id.* at 58484 (to be codified at 12 C.F.R. § 226.18(t)).

46. *Id.* (to be codified at 12 C.F.R. § 226.18(t)(2)); *see also id.* at 58486 (to be codified at 12 C.F.R. pt. 226, app. H, model clause H-4(k)).

47. *Id.* at 58483 (to be codified at 12 C.F.R. § 226.18(s)(5), (6)).

48. *Id.* at 58471; *see also* MDIA, *supra* note 42, § 2502(c), 122 Stat. at 2857 (codified at 15 U.S.C.A. § 1638 note (West 2009)).

49. Disclosure Requirements Interim Rule, *supra* note 41, 75 Fed. Reg. at 58472.

50. *Id.*

51. *See* Truth in Lending, 75 Fed. Reg. 50801 (Aug. 17, 2010) (to be codified at 12 C.F.R. pt. 226); *see also* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Aug. 16, 2010), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20100816e.htm.

52. *See* Regulation Z; Truth in Lending, 75 Fed. Reg. 58539 (proposed Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226) [hereinafter Home-Secured Credit Proposed Rule]. For a review of the first phase of the proposed rules, see Jacqueline A. Parker, Jeffrey P. Naimon, Catherine M. Brennan & Kirk D. Jensen, *Truth in Lending Update—2009*, 65 Bus. Law. 523, 525–26 (2010) (in the 2010 *Annual Survey*).

53. Home-Secured Credit Proposed Rule, *supra* note 52, 75 Fed. Reg. at 58546. The proposal revises the list of disclosures, that if not properly made, could trigger an extended right to rescind a mortgage. *Id.* at 58686.

54. *Id.* at 58627.

The proposal would amend the rules for determining when a modification of an existing home-secured closed-end loan is a new transaction requiring new disclosures.[55] The rules for determining whether a closed-end loan secured by the consumer's principal dwelling is a "higher-priced" mortgage loan subject to special protections under the regulation for subprime loans would be revised to ensure that prime loans are not improperly classified.[56] Consumers would receive a right to a refund of fees within three business days of receiving the cost disclosures if an application is withdrawn.[57] In addition, a loan servicer would be required to provide certain information to a consumer requesting the information, within a reasonable time after the request, which would generally be ten business days.[58]

Reverse Mortgages

The timing, content, and format of the disclosures for open- and closed-end reverse mortgages would also be amended to help consumers understand features that are unique to reverse mortgages.[59] At application, consumers would receive a two-page disclosure that highlights the basic features and risks of a reverse mortgage.[60] Consumers would receive transaction-specific disclosures in a tabular format with the actual terms of the reverse mortgage within three days after the creditor receives the application and at least three days before closing.[61]

The proposal would also prohibit certain unfair acts or practices for reverse mortgages. Creditors would be prohibited from conditioning a reverse mortgage on the consumer's purchase of another financial or insurance product, such as an annuity, so that consumers are not forced to buy products that can be costly or may not be considered beneficial.[62] The advertising rules for reverse mortgages would require accurate and balanced statements with clear disclosures.[63] In an effort to help consumers understand reverse mortgages, a creditor could not extend a reverse mortgage or charge a nonrefundable fee without the consumer first obtaining counseling about the mortgage (although a fee may be imposed for the counseling).[64] In addition, to help ensure unbiased counseling, creditors would be prohibited from steering consumers to specific reverse mortgage counselors, or compensating counselors or counseling agencies.[65]

The advertising rules for home-equity lines of credit would be conformed to the rules adopted in 2008 for closed-end mortgage loans, and the disclosure rules

55. *Id*. at 58595–96.
56. *Id*. at 58548.
57. *Id*. at 58540.
58. *Id*. at 58783.
59. *Id*. at 58549–50.
60. *Id*. at 58774.
61. *Id*. at 58541, 58699.
62. *Id*. at 58551.
63. *Id*. at 58540.
64. *Id*.
65. *Id*.

related to credit insurance and debt cancellation and suspension products would be revised to ensure full disclosure to consumers of the costs and risk of these products.[66] Comments to the proposal were due on December 23, 2010, and the FRB intends to issue final rules that combine the 2009 and 2010 proposals.[67]

Revised Escrow Account Requirements for Jumbo Mortgages

The proposal also intends to revise the escrow account requirements for higher-priced, first-lien "jumbo" mortgage loans that exceed the conforming loan-size limit for purchase by Freddie Mac.[68] The proposal, which implements a provision of the Dodd-Frank Act,[69] would increase the annual percentage rate ("APR") threshold used to determine whether a mortgage lender must establish an escrow account for property taxes and insurance for first-lien jumbo mortgage loans.[70]

In July 2008, the FRB issued final rules requiring creditors to establish escrow accounts for first-lien loans if a loan's APR is 1.5 percentage points or more above the applicable prime offer rate.[71] Under the Dodd-Frank Act, which amended TILA, the escrow requirement will apply for jumbo loans only if the loan's APR is 2.5 percentage points or more above the applicable prime offer rate.[72] The APR threshold for non-jumbo loans remains unchanged. The Dodd-Frank Act incorporates into TILA the FRB's regulatory requirement for escrow accounts and revises the APR threshold, but the Dodd-Frank Act also includes other provisions, including new disclosure requirements.[73] The proposal would implement only the Dodd-Frank Act's change to the APR threshold; the FRB indicated that it will implement other provisions of the Dodd-Frank Act concerning escrow accounts in a separate rulemaking.[74]

The FRB sought comment on the proposed rule, including the appropriate implementation date, for thirty days after publication in the *Federal Register*.[75]

TILA Litigation

Although the amount of TILA litigation in federal and state courts has continued at a significant level, most likely due to the increasing number of initiated foreclosures and consumer bankruptcy filings, there were fewer critical court decisions under

66. *Id.* at 58540–41.
67. *Id.* at 58539.
68. Regulation Z; Truth in Lending, 75 Fed. Reg. 58505, 58506–08 (proposed Sept. 24, 2010) (to be codified at 12 C.F.R. § 226.35(v)) [hereinafter Higher-Priced Loans Proposal].
69. *See supra* note 3.
70. Dodd-Frank Act, *supra* note 3, § 1461, 124 Stat. at 2178–81 (to be codified at 15 U.S.C. § 1639d).
71. Truth in Lending, 73 Fed. Reg. 44522, 44603–04 (July 30, 2008) (to be codified at 12 C.F.R. § 226.35).
72. Dodd-Frank Act, *supra* note 3, § 1461, 124 Stat. at 2178–79 (to be codified at 15 U.S.C. § 1639d(b)(3)(B)).
73. *See id.*, 124 Stat. at 2180–81 (to be codified at 15 U.S.C. § 1639d(h)).
74. Higher-Priced Loans Proposal, *supra* note 68, 75 Fed. Reg. at 58506.
75. *Id.*

TILA in the past year. However, several issues continued to generate substantial litigation, including rescission and the requirements for actual damages under TILA.[76]

In probably the most closely watched TILA case in the past year, *Vallies v. Sky Bank*,[77] the U.S. Court of Appeals for the Third Circuit addressed whether actual damages under TILA require a showing of detrimental reliance. Both consumer advocates and industry groups filed amicus curiae briefs with the court, indicating the criticality of the question.[78] The principal argument set forth by the plaintiffs was that requiring detrimental reliance to obtain actual damages under TILA is at odds with the remedy provisions set forth in both regulatory enforcement provisions and the error correction provision.[79] Under each of these provisions, the creditor is generally required to refund finance charges in excess of the disclosed amounts.[80] The implicit argument made by the plaintiffs was that the consumer is entitled to the transaction disclosed under TILA, and that the finance charge difference between the disclosed transaction and the actual transaction is the "actual damage" suffered by a consumer who received an under-disclosed finance charge.[81] Notwithstanding this argument, and following a lengthy analysis of the language and structure of TILA's civil remedy provision, the Third Circuit determined that the statutory language was "unambiguous" and upheld the district court's determination that recovery of actual damages under TILA requires detrimental reliance.[82] The court further found that the legislative history to the Truth in Lending Act Amendments of 1995 supports this conclusion.[83]

There were also numerous case decisions involving consumers' attempts to exercise their right to rescind the mortgage transaction after the initial three business day period following loan consummation.[84] Such post-funding claims involve an

76. A discussion of all of the interesting trends in TILA litigation is beyond the scope of this survey, but there were many interesting cases decided in the past year. *See, e.g.*, Reagen v. Aurora Loan Servs., Inc., No. 1:09-CV-00839-OWW-DLB, 2009 WL 3789997, at *9 (E.D. Cal. Nov. 10, 2009) (negative amortization feature of the loan was properly disclosed and, even if it was not, this would not be a "material" violation for purposes of the rescission right); Henderson v. GMAC Mortg. Corp., 347 F. App'x 299, 301 (9th Cir. 2009) (upholding dismissal of a TILA claim based on affidavit of a "proposed expert" who "provided little information about where and when he obtained his education and training, [whose] conclusions lacked factual support, and the opinions he provided required no scientific, technical, or other specialized knowledge").

77. 591 F.3d 152 (3d Cir. 2009), *aff'g* 583 F. Supp. 2d 687 (W.D. Pa. 2008); *see* Parker, Naimon, Brennan & Jensen, *supra* note 52, at 533–34 (discussing the case in last year's *Annual Survey*).

78. *Vallies*, 591 F.3d at 153. One brief was filed on behalf of three leading consumer advocacy groups, and the other on behalf of nine industry trade groups. *Id.*

79. *Id.* at 159–60 (citing 15 U.S.C. §§ 1607 (regulatory enforcement), 1640(b) (error correction)).

80. *See id.*

81. *Id.*

82. *Id.* at 158.

83. *Id.* at 158–59 (quoting Senator Mack, one of the sponsors of the 1995 legislation, to the effect that "[s]tatutory damages are provided in TILA because actual damages, which require proof that the [consumer] suffered a loss in reliance upon the inaccurate disclosure, are extremely difficult to establish").

84. *See, e.g.*, Bonte v. U.S. Bank, N.A., 624 F.3d 461, 463 (7th Cir. 2010) ("Because the Bontes seek rescission of their loan well outside the ordinary three-day period allowed under TILA, *see* 15 U.S.C. § 1635(a); 12 C.F.R. § 226.23(a)(3), they must demonstrate that the lender failed to make a required "material" disclosure, *see* 15 U.S.C. § 1635(f) (extending right of rescission to earlier of three years or until the sale of the property) . . . .").

allegation that the consumer did not receive all of the required material TILA disclosures, or that the "material" disclosures were sufficiently flawed to merit rescission.[85] Because a successful rescission involves the refund to the borrower of both the closing costs and all finance charges paid up to the time of the rescission, such claims are often among the most attractive statutory claims available to consumers. As noted in last year's *Annual Survey*, because of the substantial nature of the remedy, and the technical nature of many alleged TILA violations, some courts have questioned whether TILA's rescission remedy is appropriate for technical violations.[86] Notwithstanding such concerns, most courts continue to hold that technical errors can result in a rescission. For example, in *Rojo v. U.S. Bank N.A.*,[87] the court held that a failure to provide two copies of the notice of the right to rescind (a very common allegation) would be sufficient to merit rescission.[88]

85. *See* 12 C.F.R. § 226.23(a)(3) n.48 (2010) (providing that "[t]he term 'material disclosures' means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, and the disclosures and limitations referred to in §§ 226.32(c) and (d) and 226.35(b)(2)").

86. *See*, *e.g.*, Melfi v. WMC Mortg. Corp., 568 F.3d 309, 311–12 (1st Cir. 2009).

87. No. 09-C-0229, 2010 WL 1292280, at *4 (E.D. Wis. Mar. 29, 2010) (the Seventh Circuit still takes a technical violation approach).

88. *See id.* at *4–5, *discussed in* Parker, Naimon, Brennan & Jensen, *supra* note 52, at 529–32. Because the rescission right, and related disclosures, were crafted to create a cooling-off period in home improvement transactions involving the taking of a lien, rather than in the standard residential mortgage refinancing transaction, the language of the rights and the related notices has long created confusion in its most common use. *See* Home-Secured Credit Proposed Rule, *supra* note 52, 75 Fed. Reg. at 58546 ("Consumer testing shows that consumers may have difficulty understanding the explanation of the right of rescission in the current model forms. Consumers struggled with determining when the deadline to rescind expires, based on the later of consummation, delivery of the material disclosures, or delivery of the notice of the right to rescind."). In light of the substantial amount of litigation and confusion that has arisen in this area, as part of the FRB's comprehensive review of Regulation Z, the FRB paid considerable attention to the TILA rescission right. As a result, the FRB has issued a proposed rule that is intended to clarify many of the requirements that arise in the extended, post-three business day rescission period. *See supra* notes 52–58 and accompanying text.

Update on CARD Act Rules—Credit Cards

*By Obrea Poindexter**

Introduction

The Federal Reserve Board ("FRB") continues to implement the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "CARD Act"),[1] which was signed into law by President Obama on May 22, 2009. Although the CARD Act includes certain protections that mirror those under the January 2009 FRB Regulation Z Rule[2] and the January 2009 FTC Act Rule,[3] the CARD Act also expanded cardholder protections and creditor obligations in ways beyond those contained in the 2009 rules.

The CARD Act provisions had varying effective dates. Certain provisions of the CARD Act became effective on August 20, 2009. Two other provisions became effective on August 22, 2010. However, the majority of the CARD Act went into effect on February 22, 2010.[4] This survey is not a comprehensive discussion of all of the CARD Act rules; instead, the discussion focuses on key provisions of the two primary rules implementing the CARD Act.[5]

CARD Act Provisions Effective on February 22, 2010

Summary of Effective Dates

The majority of the CARD Act requirements, including the provisions regarding limitations on retroactive interest rate increases, over-the-limit transactions, and the ability to assess a cardholder's ability to repay credit card obligations, went

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* Obrea Poindexter is of counsel in the Financial Services Practice Group of Morrison & Foerster in Washington, D.C. and Vice Chair of the Privacy Subcommittee of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law.

1. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (to be codified in scattered sections of 15 U.S.C.) [hereinafter CARD Act].

2. Truth in Lending, 74 Fed. Reg. 5244 (Jan. 29, 2009) (to be codified at 17 C.F.R. pt. 226) (subsequently withdrawn).

3. Unfair or Deceptive Acts or Practices, 74 Fed. Reg. 5498 (Jan. 29, 2009) (to be codified at 12 C.F.R. pts. 227, 535 & 706) (subsequently withdrawn).

4. CARD Act, *supra* note 1, § 3, 124 Stat. at 1735 (to be codified at 15 U.S.C. § 1602 note).

5. For further background, see Rick Fischer, David Laudicina & Obrea Poindexter, *The New Credit Card Rules*, 65 Bus. Law. 537 (2010) (in the 2010 *Annual Survey*); Stanton Koppel, Nicole Ibbotson & Helen Y. Lee, *Credit CARD Act of 2009: Implementation Guidelines*, 63 Consumer Fin. L.Q. Rep. 205 (2009).

into effect in February 2010, which was nine months after enactment.[6] Leaving issuers with less than two months to implement its extensive requirements, on January 12, 2010, the FRB issued a final rule (the "January 2010 Rule") to implement the CARD Act provisions that went into effect in February 2010.[7] The January 2010 Rule also incorporated the substance of the Regulation Z rule issued by the FRB in January 2009 (the "January 2009 Rule").[8] Because the substance of many of the requirements of the January 2009 Rule, and amendments to Regulation AA (the "FTC Act Rule"), were incorporated into the January 2010 Rule, the FRB simultaneously issued notices withdrawing the January 2009 Rule[9] and the FTC Act Rule.[10]

The effective date of the January 2010 Rule was February 22, 2010.[11] The mandatory compliance date for a majority of the CARD Act provisions also was February 22, 2010.[12] However, the FRB maintained the original mandatory compliance date of July 1, 2010, for most of the Regulation Z provisions included in the January 2009 Rule and for certain formatting provisions.[13]

Prohibition on Retroactive Rate Increases (Section 226.55)

The CARD Act prohibits an issuer from increasing any rate, fee, or finance charge and applying the increase to the outstanding balance on an open-end consumer credit plan, with four exceptions.[14] The January 2010 Rule adopts the prohibition on an issuer imposing a rate increase, or certain fee increases applicable to an account, unless one of the express exceptions applies.[15] However, the FRB included in the January 2010 Rule several modifications and clarifications concerning the general prohibition and the operation and applicability of certain exceptions.

Variable Rate Exception (Section 226.55(b)(2))

With no prior public discussion in the proposal or otherwise, the January 2010 Rule significantly departs from the statutory language of the variable rate exception contained in the CARD Act. Under the CARD Act, an issuer would have been allowed to impose a rate increase on the existing account balance without

6. CARD Act, *supra* note 1, § 3, 124 Stat. at 1735 (to be codified at 15 U.S.C. § 1602 note).

7. Truth in Lending, 75 Fed. Reg. 7658 (Feb. 22, 2010) (to be codified at 12 C.F.R. pt. 226 (2010)) [hereinafter January 2010 Rule]. The FRB issued this rule on January 12, 2010. *Id.* at 7658.

8. *Id.* at 7659; *see also* Truth in Lending, 74 Fed. Reg. 5244 (Jan. 29, 2009); *supra* note 5.

9. Truth in Lending, 75 Fed. Reg. 7925 (Feb. 22, 2010).

10. Unfair or Deceptive Acts or Practices, 75 Fed. Reg. 7925 (Feb. 22, 2010).

11. January 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7658.

12. CARD Act, *supra* note 1, § 3, 124 Stat. at 1735 (to be codified at 15 U.S.C. § 1602 note).

13. January 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7659–60. Regulation Z, 12 C.F.R. pt. 226 (2010), is promulgated by the FRB to implement the federal Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C.A. §§ 1601–1667f (West 2009 & Supp. 2010)). *See generally* Catherine M. Brennan, Jeffrey P. Naimon & Jacqueline A. Parker, *Truth in Lending Update—2010*, 66 Bus. Law. 413 (2011) (in this *Annual Survey*).

14. CARD Act, *supra* note 1, § 101(b), 123 Stat. at 1736 (to be codified at 15 U.S.C. § 1666i-1).

15. January 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7819 (to be codified at 12 C.F.R. § 226.55).

prior notice if the increase was based on an increase in an index that is not under the control of the issuer and the index is available to the general public.[16] The January 2010 Rule states for the first time, however, that a variable rate formula with a rate floor is deemed to be under the control of the issuer and, thus, does not qualify for the exception from the notice requirement or the prohibition on applying a rate increase to an existing balance.[17] The FRB explained that, based on comments from consumer groups and members of Congress, the FRB revised section 226.55(b)(2)-2.ii of the FRB Official Staff Commentary to Regulation Z ("Commentary") to provide that, for purposes of the variable rate exception, an index is under an issuer's control if "[t]he variable rate is subject to a fixed minimum rate or similar requirement that does not permit the variable rate to decrease consistent with reductions in the index."[18]

In addition, an example is included in the Commentary to the January 2010 Rule stating that "[i]f the terms of the account provide that the variable rate will not decrease below 15% even if the index decreases below 10%, the card issuer cannot increase that rate pursuant" to the variable rate exception.[19] Accordingly, if the variable rate feature includes a floor, the variable rate exception does not apply.

The implementation guidance on this provision accompanying the January 2010 Rule[20] is less than clear. An issuer should not be required to provide a forty-five day advance notice of the method used to calculate the variable rate because such a change would result in reduction in an interest rate component that could be only beneficial for consumers. Nevertheless, the implementation guidance also provides that an issuer is not required to provide a "right to reject for changes . . . to the method used to calculate a variable rate necessary to comply with" the variable rate exception.[21] Furthermore, under the January 2010 Rule, a card issuer imposing a rate floor for a variable rate program was required to comply with these provisions as of February 22, 2010.[22]

Temporary Rate Exception (Section 226.55(b)(1))

Under the January 2010 Rule, an issuer may increase a rate at the expiration of a specified period of time if: (i) the issuer discloses in writing both the length of the period and the "go to" rate that will apply at the expiration of the period; (ii) the rate increase does not exceed the previously disclosed rate; and (iii) the increased rate does not apply to transactions that occurred before the rate reduction

16. CARD Act, *supra* note 1, § 101(b), 123 Stat. at 1736 (to be codified at 15 U.S.C. § 1666i-1(b)(2)).

17. January 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7737, 7909 (to be codified at 12 C.F.R. pt. 226, cmt. 55(b)(2)-2).

18. *Id*.

19. *Id*. at 7909 (to be codified at 12 C.F.R. pt. 226, cmt. 55(b)(2)-2.ii).

20. *Id*. at 7782.

21. *Id*. at 7783.

22. *Id*. at 7658.

period.[23] The January 2010 Rule also provides that all rate reductions must be for a minimum of six months.[24] Specifically, the January 2010 Rule states that the six-month period begins from the time the rate reduction is available to the consumer for making purchases or from the date of the transaction, as specified by the issuer in the terms of the rate reduction.[25]

To address concerns about unnecessarily delaying the application of promotional rate offers that are made by telephone,[26] the January 2010 Rule also provides that the timing requirements are met if written disclosures are provided as soon as reasonably practicable after the first transaction subject to the temporary rate if: (i) the consumer accepts the offer by telephone; (ii) written promotional disclosures are later provided to the consumer; and (iii) an issuer then permits the consumer to reject the rate offer and to reinstate the rate that previously applied.[27]

Sixty-Day Delinquency Exception (Section 226.55(b)(4))

The January 2010 Rule provides that a rate, fee, or finance charge may be increased, and that increase applied to the outstanding balance, if the consumer has not made a minimum payment within sixty days.[28] The January 2010 Rule does not, however, give issuers the ability to provide consumers with a dual notice. That is, an issuer is not permitted to provide a forty-five day advance written notice informing a consumer of an increased rate due to delinquency that impacts new transactions and, in the same notice, simultaneously inform the consumer that the increased rate due to delinquency also would apply to the existing balance should the consumer become sixty days delinquent after the notice is provided.[29] Since issuers are not permitted to use such a dual notice, the January 2010 Rule essentially eliminates a true sixty-day delinquency exception, but instead requires an issuer to provide a second forty-five day advance written notice after the consumer has become sixty days delinquent, thus essentially transforming the sixty-day delinquency exception into a 105-day delinquency exception.[30]

Workout and Temporary Hardship Exception (Section 226.55(b)(5))

The January 2010 Rule provides that a rate or fee increase is permitted upon the consumer's completion of, or failure to comply with the terms of, a workout or temporary hardship arrangement, provided that certain written disclosures are delivered prior to the commencement of the arrangement.[31] However, the Com-

23. *Id*. at 7819 (to be codified at 12 C.F.R. § 226.55(b)(1)).
24. *Id*.
25. *Id*. at 7908 (to be codified at 12 C.F.R. pt. 226, cmt. 55(b)(1)-2).
26. *Id*. at 7698.
27. *Id*. at 7884 (to be codified at 12 C.F.R. pt. 226, cmt. 9(c)(2)(v)-5).
28. *Id*. at 7819–20 (to be codified at 12 C.F.R. § 226.55(b)(4)).
29. *Id*. at 7740.
30. *Id*.
31. *Id*. at 7820 (to be codified at 12 C.F.R. § 226.55(b)(5)).

mentary provides flexibility that was not in the original proposal. Specifically, the Commentary states that while the disclosure requirements for this section "must generally be provided in writing prior to the commencement of the arrangement," an issuer may provide such disclosures "orally by telephone, provided that the card issuer mails or delivers a written disclosure of the terms . . . as soon as reasonably practicable after the oral disclosure is provided."[32]

Servicemembers Civil Relief Act Exception (Section 226.55(b)(6))

The January 2010 Rule permits an issuer to impose a rate increase if an issuer decreases a rate as required by the Servicemembers Civil Relief Act once that mandated rate limitation no longer applies.[33] However, the January 2010 Rule remains silent regarding the ability of an issuer to raise a rate under a comparable state statute.

Consideration of Ability to Pay (Section 226.51)

The CARD Act prohibits an issuer from opening a credit card account for a consumer, or increasing the credit limit of a consumer's existing account, "unless the card issuer considers the ability of the consumer to make the required payments under the terms of [the] account."[34] In implementing this statutory provision, the FRB requires an issuer to consider a consumer's ability to make the required minimum periodic payments under the terms of the account based on the consumer's income or assets, and the consumer's current obligations, before opening a new account or increasing the credit limit on an existing account.[35] However, the January 2010 Rule both expands and clarifies this requirement in several important ways.

First, the January 2010 Rule clarifies that, similar to the provision permitting an issuer to rely on information about current obligations received from a consumer reporting agency,[36] an issuer also may rely on income or asset information from several sources, including consumer reports from consumer reporting agencies and information from other parties.[37] Specifically, for example, to address concerns about the difficulty of obtaining income data in the context of prescreened offers, account acquisition at the point of sale, or in connection with credit line increases, the Commentary provides that "[a] card issuer may also consider information obtained through any empirically derived, demonstrably and statistically sound model that reasonably estimates a consumer's income or assets."[38] All three

32. *Id*. at 7911 (to be codified at 12 C.F.R. pt. 226, cmt. 55(b)(5)-2).
33. *Id*. at 7820 (to be codified at 12 C.F.R. § 226.55(b)(6)).
34. CARD Act, *supra* note 1, § 109, 123 Stat. at 1743 (to be codified at 15 U.S.C. § 1665e).
35. January 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7818 (to be codified at 12 C.F.R. § 226.51(a)).
36. *Id*. at 7900 (to be codified at 12 C.F.R. pt. 226, cmt. 51(a)(1)-5).
37. *Id*. (to be codified at 12 C.F.R. pt. 226, cmt. 51(a)(1)-4).
38. *Id*.

consumer reporting agencies reportedly have developed individual income estimator products that are empirically derived and demonstrably and statistically sound, consistent with the standards for a validated credit scoring system under the FRB's Regulation B promulgated under the Equal Credit Opportunity Act.[39] Thus, the January 2010 Rule clarifies that an issuer is not obligated to obtain the necessary income or asset information from a consumer.[40] Instead, the January 2010 Rule permits an issuer to meet the requirement to consider income by the issuer's evaluation of consumer report information, together with a consumer reporting agency's or other third party's evaluation of consumer-specific income information through use of a qualified estimator model.[41]

Second, however, based on comments from consumer groups urging the FRB to include additional guidance on how an issuer should evaluate a consumer's income or assets and obligations,[42] the January 2010 Rule includes a new provision stating that reasonable policies and procedures to consider a consumer's ability to pay must be in writing and must include "at least one of the following: [t]he ratio of debt obligations to income; the ratio of debt obligations to assets; or the income the consumer will have after paying debt obligations."[43] While an issuer's evaluation of a consumer's ability to pay must include a debt-to-income component,[44] an issuer is permitted to consider other factors in determining a consumer's ability to pay, consistent with an issuer's overall underwriting practices.[45] It should be noted that the January 2010 Rule specifically states that an issuer is required to establish reasonable "written" policies and procedures for determining a consumer's ability to pay.[46]

Third, the January 2010 Rule clarifies that while the safe harbor for estimating the required minimum periodic payments for the account for which the consumer is applying requires an issuer to assume full utilization at the time the account is opened, a card issuer need not assume full utilization in evaluating a consumer's current obligations in connection with an existing account.[47]

Partial Grace Requirement (Section 226.54)

The regulatory text of the January 2010 Rule mirrors the CARD Act by providing that an issuer offering a grace period is prohibited from imposing finance

39. *See* Regulation B, 12 C.F.R. §§ 202.1–202.16 (2010), implementing the Equal Credit Opportunity Act, Pub. L. No. 93-495, 88 Stat. 1500, 1521 (1974) (codified as amended at 15 U.S.C. §§ 1691–1691f (2006)); *see generally* John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, *Fair Lending Developments: Enforcement Comes to the Fore*, 66 Bus. Law. 447 (2011) (in this *Annual Survey*).

40. January 2010 Rule, *supra* note 7, 75 Fed. Reg. at 7900 (to be codified at 12 C.F.R. pt. 226, cmt. 51(a)(1)-4).

41. *Id.*

42. *Id.* at 7720.

43. *Id.* at 7818 (to be codified at 12 C.F.R. § 226.51(a)(1)(ii)).

44. *Id.*

45. *Id.* at 7900 (to be codified at 12 C.F.R. pt. 226, cmt. 51(a)(1)-1).

46. *Id.* at 7818 (to be codified at 12 C.F.R. § 226.51(a)(1)(ii)).

47. *Id.* at 7900 (to be codified at 12 C.F.R. pt. 226, cmt. 51(a)(1)-5).

charges for partial payments "as a result of the loss of a grace period on a credit card account."[48] However, the January 2010 Rule modifies the circumstances for application of the partial grace requirement.[49]

To address concerns about the application of the partial grace requirement, the FRB included language in the January 2010 Rule's Supplemental Information and Commentary that clarifies the requirement.[50] More specifically, the Supplemental Information clarifies that a card issuer that employs a less restrictive grace period eligibility requirement, such as a requirement to pay the outstanding balance in full by the due date each billing cycle, is not subject to the partial grace requirement, "unless the relevant [purchase] balance for the prior billing cycle has been paid in full before the beginning of the current cycle."[51] In addition, the Commentary examples indicate that the partial grace requirement will apply equally to grace period terms permitting a consumer to pay the outstanding balance in full by the due date of each billing cycle, as it applies to grace period terms requiring a consumer to pay the outstanding balance in full by the due date in both the previous and the current billing cycles.[52] Thus, under the January 2010 Rule, the partial grace requirement should not generally apply to consumers who are typically "revolvers," but instead should only apply in the cycle where a consumer transitions from being a "transactor" to being a "revolver"—that is, where the consumer transitions from a cycle where the consumer has paid the full balance to a cycle where the consumer pays less than the full balance.

Opt-In Required for Over-the-Limit Transactions (Section 226.56)

The rule implementing the limitations for opt-ins mirrors the statute.[53] The CARD Act prohibits an issuer from charging an over-the-limit fee when a consumer's account extends beyond the authorized credit limit, unless the consumer opts in to permit the issuer to impose such a fee when completing a transaction exceeding the applicable credit limit.[54] Before opting in, the consumer must receive a notice, in the form, manner, and time determined by the FRB, disclosing the fee for an over-the-limit transaction.[55] If a consumer opts in, the issuer must also notify the consumer, in the periodic statement covering a period in which an over-the-limit fee was imposed, of the consumer's right to rescind the opt-in.[56] A consumer may opt in at any time, and the opt-in is effective until revoked.[57] The CARD Act requires the FRB to prescribe regulations governing the disclosures

48. *Id*. at 7819 (to be codified at 12 C.F.R. § 226.54(a)(1)).
49. *Id*. at 7904 (to be codified at 12 C.F.R. pt. 226, cmt. 54(a)(1)-1).
50. *Id*. at 7731, 7904 (to be codified at 12 C.F.R. pt. 226, cmt. 54(a)(1)-1).
51. *Id*. at 7731.
52. *Id*. at 7904 (to be codified at 12 C.F.R. pt. 226, cmt. 54(a)(1)-1(i), (ii)).
53. *Id*. at 7820 (to be codified at 12 C.F.R. § 226.56).
54. CARD Act, *supra* note 1, § 102(a), 123 Stat. at 1739 (to be codified at 15 U.S.C. § 1637(k)).
55. *Id*. (to be codified at 15 U.S.C. § 1637(k)(2)).
56. *Id*.
57. *Id*. (to be codified at 15 U.S.C. § 1637(k)(4)).

required under this section, and ensure that the same options are available for both the election and revocation.[58] The CARD Act states that this should not be construed to prohibit an issuer from completing an over-the-limit transaction, provided that a consumer who has not made the opt-in election is not charged an over-the-limit fee on the transaction.[59] Also, nothing in the CARD Act prevents an issuer from rejecting over-the-limit transactions.[60]

An issuer may impose an over-the-limit fee only on an account that has exceeded its credit limit once during a billing cycle.[61] Additionally, an over-the-limit fee may be imposed only once during each of the two subsequent billing cycles, "unless the consumer has obtained an additional extension of credit in excess of [the] credit limit during any such subsequent cycle or the consumer reduces the outstanding balance below the credit limit as of the end of such billing cycle."[62]

CARD Act Provisions Effective on August 22, 2010

Issuance of the June 2010 Rule

On June 15, 2010, the FRB issued another final rule (the "June 2010 Rule")[63] to implement the reasonable penalty fee and rate reevaluation provisions of the CARD Act.[64] For all practical purposes, the June 2010 Rule completely transformed the preexisting penalty fee structure for the entire credit card industry and requires issuers to reevaluate rate increases for a potentially indefinite period of time.

The June 2010 Rule became effective August 22, 2010.[65] The mandatory compliance date for the Regulation Z change-in-terms notice requirements (section 226.9), the penalty fee provisions (section 226.52), and the rate reevaluation provisions (section 226.59) was August 22, 2010.[66] However, in recognition of the inadequate time issuers had to revise account-opening disclosures and other related disclosures to reflect fee modifications and related changes,[67] the mandatory compliance date for the penalty fee provisions included in applications and account-opening disclosures (sections 226.5a and 226.6), periodic statements (section 226.7), and other related disclosure requirements was December 1, 2010.[68]

58. *Id.* (to be codified at 15 U.S.C. § 1637(k)(5)).
59. *Id.* (to be codified at 15 U.S.C. § 1637(k)(6)).
60. *Id.*
61. *Id.* (to be codified at 15 U.S.C. § 1637(k)(7)).
62. *Id.*
63. Truth in Lending, 75 Fed. Reg. 37526 (June 29, 2010) (to be codified at 12 C.F.R. pt. 226) [hereinafter June 2010 Rule].
64. CARD Act, *supra* note 1, § 101(c), 123 Stat. at 1737 (to be codified at 15 U.S.C. § 1665c) (rate reevaluation); *id.* § 102(b), 123 Stat. at 1740 (to be codified at 15 U.S.C. § 1665d) (reasonable penalty fees).
65. June 2010 Rule, *supra* note 63, 75 Fed. Reg. at 37526.
66. *Id.*
67. *Id.* at 37563.
68. *Id.* at 37526.

Reasonable and Proportional Penalty Fees (Section 226.52(b))

The CARD Act prohibits an issuer from imposing a penalty fee or charge in connection with any omission or violation of the cardholder agreement (including any late payment, over-the-limit, or other penalty fee) unless the fee is "reasonable and proportional" to the omission or violation.[69] Accordingly, the implementing provision of the June 2010 Rule prohibits an issuer from imposing a penalty fee for violating the terms or other requirements of an account, unless the dollar amount of the penalty fee is based on either the costs incurred by the issuer as a result of that particular type of violation, as set forth in the June 2010 Rule, or, in the alternative, is based on the safe harbor amounts established in the June 2010 Rule itself.[70] After reviewing industry comments and further analysis, the FRB did not adopt a deterrence standard as part of the June 2010 Rule.[71] Instead, the June 2010 Rule incorporates deterrence into the revised safe harbor structure by allowing an issuer to impose higher fees for repeated violations during a subsequent period of six billing cycles.[72]

Safe Harbor

The safe harbor amount for the first violation of a particular type is $25, and the amount for an additional violation of the same type (for example, a second late payment) during the next six billing cycles is $35.[73] Accordingly, an issuer is permitted to assess a $35 penalty fee on a rolling basis for a particular type of violation for six months following that violation.[74] For instance, the June 2010 Rule clarifies that if a consumer pays late in March and April, the six billing cycle period runs from the violation in April, rather than the violation in March, and, thus, a $35 late fee can be imposed not only for a late payment in April, but also for a late payment during the months of May, June, July, August, September, or October.[75]

The June 2010 Rule also applies to charge card accounts.[76] In this regard, when an issuer has not received the required payment for a charge card account that requires a consumer to pay the entire balance in full, the safe harbor late fee amount is 3 percent of the delinquent outstanding balance once the account becomes sixty days delinquent; prior to that, the late fee amount would be based on the safe harbor or the cost determination.[77]

69. CARD Act, *supra* note 1, § 102(b), 123 Stat. at 1740 (to be codified at 15 U.S.C. § 1665d(a)).
70. June 2010 Rule, *supra* note 63, 75 Fed. Reg. at 37571 (to be codified at 12 C.F.R. § 226.52(b)).
71. *Id.* at 37533.
72. *Id.*
73. *Id.* at 37572 (to be codified at 12 C.F.R. § 226.52(b)(1)(ii)(A), (B)).
74. *Id.*
75. *Id.* at 37587 (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(1)(ii)-1.iii.A).
76. *Id.* at 37572 (to be codified at 12 C.F.R. § 226.52(b)(1)(ii)(C)).
77. *Id.*

Cost Determination

The June 2010 Rule provides that a penalty fee is reasonable and proportional if it represents a reasonable proportion of the total costs incurred by an issuer as a result of all violations of the same type.[78] The June 2010 Rule states, however, that "[t]he fact that a card issuer's fees . . . are comparable to fees assessed by other card issuers does not satisfy" the requirements of the June 2010 Rule.[79] With respect to the cost determination method of establishing a penalty fee, the June 2010 Rule does not permit an issuer to consider "[l]osses and associated costs (including the cost of holding reserves against potential losses and the cost of funding delinquent accounts)" nor the "[c]osts associated with evaluating whether consumers who have not violated the terms or other requirements of an account are likely to do so in the future."[80] However, once a violation has occurred, the costs associated with preventing additional violations, for a reasonable period of time, can be factored into an issuer's cost determination.[81]

Moreover, the June 2010 Rule provides that an issuer may consider fees that it is unable to collect when determining the appropriate fee amount.[82] The June 2010 Rule states: "Fees that the card issuer is unable to collect include fees imposed on accounts that have been charged off by the card issuer, fees that have been discharged in bankruptcy, and fees that the card issuer is required to waive in order to comply with a legal requirement."[83]

Prohibited Fees

Fees Exceeding Amount Associated with Violation

The June 2010 Rule prohibits the imposition of penalty fees that exceed the dollar amount associated with the violation.[84] Thus, for example, if a consumer fails to make a $20 minimum payment by the due date, the late payment fee cannot exceed $20, even though the safe harbor otherwise would permit imposition of a $25 fee for the first violation and a $35 fee for a subsequent violation within the next six billing cycles.[85]

Multiple Fees Based on a Single Event

The June 2010 Rule also prohibits an issuer from imposing more than one fee for violating the terms or other requirements of an account based on a single event or transaction.[86] Accordingly, an issuer is effectively precluded from imposing a

78. *Id*. at 37571–72 (to be codified at 12 C.F.R. § 226.52(b)(1)(i)).
79. *Id*. at 37585 (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(1)(i)-4).
80. *Id*. (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(1)(i)-2).
81. *Id*.
82. *Id*. at 37585–86 (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(1)(i)-5).
83. *Id*.
84. *Id*. at 37572 (to be codified at 12 C.F.R. § 226.52(b)(2)(i)(B)).
85. *Id*. at 37588 (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(2)(i)-1).
86. *Id*. at 37572 (to be codified at 12 C.F.R. § 226.52(b)(2)(ii)).

late fee and a returned payment fee in the same billing cycle. However, there may be instances in which an issuer is permitted to impose a late fee and an over-the-limit fee in the same cycle.

Declined Transaction Fees

Based on the FRB's rationale that there is no cost associated with declining a transaction, the June 2010 Rule also prohibits an issuer from imposing a declined transaction fee.[87] However, the June 2010 Rule clarifies that returning or declining an access check is not subject to the prohibition against imposing a declined transaction fee because there are significant costs that directly result from declining payment on an access check.[88] Thus, the June 2010 Rule provides that "the dollar amount associated with declining payment on a check that accesses a credit card account is the amount of the check."[89]

Inactivity Fees

The June 2010 Rule prohibits an issuer from imposing a fee based on account inactivity.[90] Moreover, in response to consumer group concerns about circumvention of the prohibition on inactivity fees,[91] the June 2010 Rule also prohibits an issuer from imposing an annual or other fee on an account and then waiving the fee if the consumer uses the account for a particular number or dollar amount of transactions.[92] Characterizing an account fee subject to waiver, which in many cases is beneficial to consumers, as a penalty fee is inconsistent with the spirit in which such waivers are given and may cause issuers simply to cease offering such waivers. Notwithstanding this prohibition, the FRB has indicated informally that this restriction is intended to be narrowly interpreted: the Supplemental Information accompanying the June 2010 Rule clarifies that an issuer is not prohibited from offering "cash back," rewards, or similar incentives commonly offered by an issuer to encourage account usage.[93]

Reevaluation of Rate Increases (Section 226.59)

The June 2010 Rule requires an issuer that imposes a rate increase on a consumer based on credit risk, market conditions, or other risk factors to have reasonable written policies and procedures to reevaluate the rate increase no less than once every six months and, if appropriate based on that review, to provide a rate decrease.[94] An issuer is permitted to review either the same factors on which

87. *Id*. (to be codified at 12 C.F.R. § 226.52(b)(2)(i)(B)(1)).
88. *Id*. at 37589 (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(2)(i)-4).
89. *Id*.
90. *Id*. at 37572 (to be codified at 12 C.F.R. § 226.52(b)(2)(i)(B)(2)).
91. *Id*. at 37547.
92. *Id*. at 37589 (to be codified at 12 C.F.R. pt. 226, cmt. 52(b)(2)(i)-5).
93. *Id*. at 37547.
94. *Id*. at 37572 (to be codified at 12 C.F.R. § 226.59(a)).

the rate increase was originally based, or to review the factors that the issuer currently considers when setting rates applicable to its new credit card accounts.[95] The June 2010 Rule, however, requires an issuer to conduct its first two reviews for rate increases imposed between January 1, 2009, and February 21, 2010, by using the factors the issuer currently considers with respect to its new credit card accounts, except when the rate increase was based on a consumer-specific factor, such as delinquency.[96]

The FRB declined to adopt a specific time limit on an issuer's obligation to reevaluate rate increases. As a result, the June 2010 Rule requires an issuer to continue to review a consumer's account until the rate is reduced to the rate in effect prior to the increase.[97] Specifically, the June 2010 Rule provides that "[a]ny reduction . . . shall apply to . . . (A) Any outstanding balances to which the increased rate . . . has been applied; and (B) New transactions that occur after the effective date of the rate reduction that would otherwise have been subject to the increased rate."[98]

The requirement to reevaluate rate increases does not apply to rate increases for charged off accounts or rate increases following a decrease pursuant to the Servicemembers Civil Relief Act.[99]

95. *Id*. (to be codified at 12 C.F.R. § 226.59(d)(1)).
96. *Id*. (to be codified at 12 C.F.R. § 226.59(d)(2)).
97. *Id*. (to be codified at 12 C.F.R. § 226.59(f)).
98. *Id*. (to be codified at 12 C.F.R. § 226.59(a)(2)(ii)).
99. *Id*. at 37573 (to be codified at 12 C.F.R. § 226.59(h)).

2010 Survey of RESPA Developments

*By John P. Kromer, Sanford Shatz, and Jonathan W. Cannon**

Introduction

The year 2010 was one of the most significant in the history of the Real Estate Settlement Procedures Act ("RESPA")[1] and its implementing Regulation X.[2] The year began with the implementation of the long-awaited amendments to Regulation X to rewrite the core residential mortgage loan origination disclosure requirements of RESPA, including the Good Faith Estimate ("GFE") and HUD-1/1A Settlement Statements.[3] In July 2010, the reform legislation known as the Dodd-Frank Wall Street Reform and Consumer Protection Act[4] was signed into law. In addition to revising RESPA, the Dodd-Frank Act created a new independent Bureau of Consumer Financial Protection (the "CFPB") within the Federal Reserve System and provides for the transfer of the U.S. Department of Housing and Urban Development's ("HUD's") rulemaking and enforcement authority under RESPA to the CFPB on July 21, 2011.[5] Finally, RESPA litigation continued on several fronts, including several important cases addressing RESPA section 8.[6]

Revised GFE, HUD-1/1A Settlement Statement

On November 17, 2008, HUD published its final rule revising a number of sections of Regulation X with the intent of protecting consumers from "unnecessarily

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* John P. Kromer is a partner with BuckleySandler LLP in Washington, D.C. and is the Chair of the Housing Finance and RESPA Subcommittee of the Consumer Financial Services Committee of the American Bar Association Section of Business Law. Sanford Shatz is a practicing attorney in Los Angeles, California, and is the Vice Chair of the Housing Finance and RESPA Subcommittee of the Consumer Financial Services Committee of the American Bar Association Section of Business Law. Jonathan W. Cannon is an associate with BuckleySandler LLP in Los Angeles, California.

1. Real Estate Settlement Procedures Act, Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified as amended at 12 U.S.C. §§ 2601–2617 (2006)). The Dodd-Frank Act amended RESPA. *See infra* note 4.

2. 24 C.F.R. pt. 3500 (2010).

3. *See infra* notes 7–20 and accompanying text.

4. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]; *see also* Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett & Arthur B. Axelson, *Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act*, 66 Bus. Law. 457 (2011) (in this *Annual Survey*); Ralph T. Wutscher & David L. Beam, *The Dodd-Frank Act's New Federalism*, 66 Bus. Law. 519 (2011) (in this *Annual Survey*).

5. *See infra* notes 24–34 and accompanying text.

6. 12 U.S.C. § 2607 (2006).

high settlement costs" by improving disclosures and making it easier for consumers to comparison shop for mortgage loan products.[7] Specifically, HUD's final rule completely revamped the GFE disclosure and HUD-1/1A Settlement Statement, requiring loan originators to begin using the revised documents and complying with the attendant rules no later than January 1, 2010.[8]

The revised rules and forms brought about significant changes by, among other things,

- creating new GFE and HUD-1/HUD-1A settlement statement forms that facilitate the required comparison between the GFE and the settlement statement at closing; these forms are intended to ensure better compliance with the new tolerance restrictions that limit the increases between estimated and actual costs for settlement services;[9]
- limiting the charge originators may impose on consumers for delivery of the GFE, limiting the additional documents that may be required in connection with the delivery of a GFE, and requiring an affirmation by the consumer to proceed with the transaction before fees may be charged;[10]
- requiring inclusion of yield spread premiums in the "origination charge" disclosed on the GFE, and treating lender payments to mortgage brokers as a credit toward settlement charges;[11]
- requiring the delivery of a list of available settlement service providers when the loan originator allows the consumer to shop for settlement service providers;[12]
- allowing for most fees disclosed on the GFE to increase only when justified as a "changed circumstance," or when the change is a result of a borrower request;[13] and
- clarifying that all RESPA disclosures may be provided to consumers in electronic form, as long as the consumer consents to receive such disclosures in electronic form and the other specific conditions of ESIGN are met. The final rule also permits documents required to be retained under RESPA to be retained in electronic format, as long as the ESIGN requirements for document retention are met.[14]

Significantly, the final rule and revised forms create three categories of settlement charges: charges that cannot increase at settlement (basically, the originator-retained

7. Real Estate Settlement Procedures Act (RESPA): Rule to Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs, 73 Fed. Reg. 68204 (Nov. 17, 2008) (to be codified at 24 C.F.R. pts. 203 & 3500) [hereinafter RESPA Rule].

8. 24 C.F.R. § 3500.1(b)(2) (2010).

9. *See* RESPA Rule, *supra* note 7, 73 Fed. Reg. at 68248 (to be codified at 24 C.F.R. pt. 3500 app. A, app. C).

10. *Id*. at 68240 (to be codified at 24 C.F.R. § 3500.7).

11. *Id*. at 68253 (to be codified at 24 C.F.R. pt. 3500 app. C).

12. *Id*. at 68254 (to be codified at 24 C.F.R. pt. 3500 app. C).

13. 24 C.F.R. § 3500.7 (2010).

14. *See* RESPA Rule, *supra* note 7, 73 Fed. Reg. at 68243 (to be codified at 24 C.F.R. § 3500.23).

charges and transfer taxes, including the yield spread premium); charges that cannot increase in total more than 10 percent (most third-party charges that the originator requires or for which the originator identifies the provider); and charges that can increase at settlement (such as per diem interest, homeowners' insurance, and initial escrow deposit).[15] The revised HUD-1/1A contains a comparison chart that reflects the fees disclosed on the GFE and actual fees charged at settlement.[16] If a charge collected at closing exceeds the tolerance threshold, the loan originator has the opportunity to "cure" the exceeded tolerance by reimbursing to the borrower the excess amount within thirty calendar days after the settlement.[17]

These revisions marked a significant change from the pre-2010 GFE and HUD-1/1A, which did not impose any tolerance thresholds, or any accuracy and redisclosure requirements, beyond being issued in "good faith." According to HUD, the revised rules and forms are designed to "ensure that at settlement borrowers are aware of final costs as they relate to their particular mortgage loan and settlement transaction,"[18] and to facilitate shopping by consumers among various loan originators and settlement service providers.[19] HUD also stated that another goal is "limiting bait-and-switch methods whereby the originator uses the GFE to draw in a borrower and, after a significant application fee is paid or burdensome documentation demands are made, claims that a material change has resulted in a more expensive loan offering."[20]

HUD's FAQs and Other Guidance

Owing to these sweeping changes, HUD was deluged with requests from loan originators, lending regulators, and other interested parties for additional guidance. On August 13, 2009, HUD issued the first version of its informal guidance in the form of RESPA frequently asked questions ("FAQs"). By April 2, 2010, HUD had issued thirteen versions of its FAQs, running to more than 300 questions and answers.[21] Following the release of the FAQs on April 2, 2010, HUD transitioned to issuing its informal guidance in the form of the newsletter *RESPA Roundup*.[22] Also, on November 13, 2009, HUD announced a 120-day period of "restrained enforcement" for FHA-approved originators who demonstrate a "good faith effort" to implement the changes.[23]

15. *Id*. at 68248 (to be codified at 24 C.F.R. pt. 3500 app. A, app. C).
16. *See id*. at 68227–29.
17. *Id*. at 68241 (to be codified at 24 C.F.R. § 3500.7(i)).
18. *Id*. at 68204.
19. *Id*.
20. *Id*. at 68212.
21. *See New RESPA Rule FAQs*, U.S. Dep't Housing & Urb. Dev. (Apr. 2, 2010), http://www.hud.gov/offices/hsg/ramh/res/resparulefaqs422010.pdf.
22. *See RESPA Roundup*, U.S. Dep't Housing & Urb. Dev. (July 2010), http://www.hud.gov/offices/hsg/ramh/res/roundupjuly.pdf. The July 2010 issue states that HUD intends to produce issues of *RESPA Roundup* "periodically." *Id*. at 1.
23. Press Release, U.S. Dep't of Hous. & Urban Dev., HUD Announces Restraint in RESPA Enforcement for First Four Months of New Rule (Nov. 13, 2009) (No. 01-215), *available at* http://portal.hud.gov/portal/page/portal/HUD/press/press_releases_media_advisories/2009/HUDNo.09-215.

Bureau of Consumer Financial Protection and RESPA

Under the Dodd-Frank Act, authority for the interpretation and enforcement of RESPA will be transferred from HUD to the CFPB on July 21, 2011.[24] In addition to assuming all of the consumer protection obligations of HUD under RESPA, the CFPB is required to implement a combined RESPA and Truth in Lending Act ("TILA") disclosure document within one year of the transfer date (i.e., July 21, 2012), unless HUD and the Board of Governors of the Federal Reserve System (which exercises TILA interpretative authority until that authority is also transferred to the CFPB) implement a combined disclosure prior to that date.[25] Further, under the Dodd-Frank Act, state attorneys general are given the authority to bring a civil action in that state to enforce the provisions of RESPA and Regulation X.[26]

The Dodd-Frank Act also enacted a number of specific amendments to RESPA. The Dodd-Frank Act requires the CFPB to prepare and revise, at least once every five years, the "Home Buying" information booklet under section 5 of RESPA.[27] The booklet must include significantly more information than the current version of the booklet and must jointly address compliance with the requirements of RESPA and TILA.[28]

The Dodd-Frank Act also requires, in connection with certain mortgage loans, the establishment of escrow accounts.[29] Servicer-collected escrow funds must be deposited into a bank account and must be administered pursuant to RESPA, the flood insurance requirements, and state law, if applicable.[30] For loans with required escrows, the creditor must provide a notice, at least three business days

24. *See* Dodd-Frank Act, *supra* note 4, § 1062, 124 Stat. at 2039–40 (to be codified at 12 U.S.C. § 5582). On September 20, 2010, the Treasury Department announced that July 21, 2011, is the "designated transfer date" on which certain authorities are transferred to the CFPB. *See* Designated Transfer Date, 75 Fed. Reg. 57252, 57252 (Sept. 20, 2010).

25. Dodd-Frank Act, *supra* note 4, §§ 1032(f), 1098(2), 124 Stat. at 2007, 2103–04 (to be codified at 12 U.S.C. §§ 5532(f), 2603). The stated purpose of the integrated disclosure form is to "facilitate compliance with the disclosure requirements of . . . [RESPA and TILA], and to aid the borrower or lessee in understanding the transaction by utilizing readily understandable language to simplify the technical nature of the disclosures." *Id.* § 1098(2), 124 Stat. at 2103–04 (to be codified at 12 U.S.C. § 2603).

26. *Id.* § 1042, 124 Stat. at 2012–13 (to be codified at 12 U.S.C. § 5552).

27. *Id.* § 1450, 124 Stat. at 2174–76 (to be codified at 12 U.S.C. § 2604).

28. *Id.* § 1098(3), 124 Stat. at 2104 (to be codified at 12 U.S.C. § 2604). For the current booklet, see *Shopping for Your Home Loan: HUD's Settlement Cost Booklet*, U.S. Dep't of Housing & Urb. Dev., http://hud.gov/offices/hsg/ramh/res/settlement-cost-booklet03252010.cfm (last updated Aug. 17, 2010).

29. An escrow account must be established for first-lien closed-end mortgage loans when:

- federal/state law so requires;
- the loan is made, guaranteed, or insured by a federal/state lending/insuring agency;
- a first-lien mortgage loan is below the conforming loan limit and the annual percentage rate exceeds the average prime offer rate established by the Federal Reserve Board by at least 1.5 percent;
- a first-lien mortgage loan is above the conforming loan limit and the annual percentage rate exceeds the average prime offer rate by at least 2.5 percent; or
- is required by regulation.

Dodd-Frank Act, *supra* note 4, § 1461(a), 124 Stat. at 2178–79 (to be codified at 15 U.S.C. § 1639d(b)).

30. *Id.*, 124 Stat. at 2180 (to be codified at 15 U.S.C. § 1639d(g)).

before closing, that includes the following: the amount initially deposited in the escrow account; an estimate of the first year's escrow charges for estimated taxes and hazard insurance (including flood insurance); the estimated monthly amount payable for such items into escrow; and a description of the borrower's responsibilities if the account is terminated in the future.[31]

In addition, the Dodd-Frank Act provides that mortgage loan servicers must not charge fees for responding to valid qualified written requests ("QWRs").[32] The Dodd-Frank Act also shortens the time periods servicers have to respond to QWRs, and increases the penalties under section 6 of RESPA, providing for individual awards of up to $2,000 (up from $1,000) and class action awards of up to $1,000,000 (up from $500,000).[33] The Dodd-Frank Act also amended RESPA to allow for the separate disclosure on the HUD-1/1A Settlement Statement of the fee paid directly to an individual appraiser by an appraisal management company and the administration fee charged by the appraisal management company.[34]

Required Use ANPR

On June 3, 2010, HUD issued an Advance Notice of Proposed Rulemaking to seek public comment on the issue of "required use" under RESPA.[35] In its 2008 RESPA rule, HUD amended the definition of "required use" in a way that would have prohibited a non-settlement service provider (such as a homebuilder) from offering a discount on settlement services (or an upgrade on other services, such as the home) tied to the use of a particular settlement service provider (such as the homebuilder's affiliated mortgage company).[36] This amendment was withdrawn by HUD amid industry complaints and litigation.[37] According to HUD, the requested comments may be used to inform a future revision or clarification of section 8 of RESPA, which prohibits the "required use" of an affiliated settlement service provider.[38] Comments were due by September 1, 2010.[39]

31. *Id.*, 124 Stat. at 2180–81 (to be codified at 15 U.S.C. § 1639d(h)).

32. *Id.* § 1463(a), 124 Stat. at 2182 (to be codified at 12 U.S.C. § 2605(k)(1)(B)).

33. *Id.* § 1463(b), 124 Stat. at 2184 (to be codified at 12 U.S.C. § 2605(f)). Servicers must acknowledge receipt of the QWR within five days (significantly reduced from the prior deadline of twenty days), and must take action on the QWR within thirty days (down from sixty days). *Id.* § 1463(c), 124 Stat. at 2184 (to be codified at 12 U.S.C. § 2605(e)). The thirty-day period may be extended for not more than fifteen days if the servicer notifies the consumer of the delay. *Id.* (to be codified at 12 U.S.C. § 2605(e)(4)).

34. *Id.* § 1475, 124 Stat. at 2200 (to be codified at 12 U.S.C. § 2603).

35. Real Estate Settlement Procedures Act (RESPA): Strengthening and Clarifying RESPA's "Required Use" Prohibition Advance Notice of Proposed Rulemaking, 75 Fed. Reg. 31334 (June 10, 2010) (to be codified at 24 C.F.R. pt. 3500) [hereinafter June 2010 ANPR].

36. RESPA Rule, *supra* note 7, 73 Fed. Reg. at 68234 (to be codified at 24 C.F.R. § 3500.2). The proposed definition would have been effective January 16, 2009. *See id.* at 68239–40.

37. Real Estate Settlement Procedures Act (RESPA): Rule to Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs; Withdrawal of Revised Definition of "Required Use," 74 Fed. Reg. 22822 (May 15, 2009) (to be codified at 24 C.F.R. pt. 3500); Nat'l Ass'n of Home Builders, NVR, Inc. v. Preston, No. 1:08-cv-013240 CMH/TCB (E.D. Va. filed Dec. 22, 2008).

38. June 2010 ANPR, *supra* note 35, 75 Fed. Reg. at 31334–35.

39. *Id.* at 31335.

Home Warranty Marketing Interpretive Rule

On June 25, 2010, HUD published an interpretive rule discussing whether compensation paid by home warranty companies ("HWCs") to real estate brokers and agents violates the anti-kickback provisions of section 8 of RESPA.[40] Under this rule, HUD will first determine whether the compensation is (i) contingent on an arrangement that prohibits the real estate broker or agent from performing services for other HWCs (this may be evidenced by a real estate broker or agent being compensated for performing HWC services for only one company); and (ii) based on, or adjusted to reflect, the number of transactions referred by the real estate broker or agent.[41] The interpretive rule also clarifies HUD's method of determining whether services were "actually performed" by the real estate broker or agent and whether the compensation is "reasonably related" to the value of the service provided.[42] HUD's interpretive rule emphasizes that services performed by real estate brokers and agents on behalf of HWCs are compensable as additional settlement services if the services are actual, necessary, and distinct from the primary services provided by the real estate broker or agent.[43] Further, the real estate broker or agent may accept a portion of the charge for the homeowner warranty only if the broker or agent provides services that are not nominal and for which there is not a duplicative charge.[44]

RESPA Litigation

Some of the most significant litigation involving RESPA centered around claims of violations of section 8(b), which prohibits fee splitting among settlement service providers and the charging of unearned fees.[45] In 2001 HUD issued its formal Statement of Policy 2001-1, in which it contended that one settlement service provider's marking up the cost of another settlement service provider's goods or services, without providing additional goods or services, violates RESPA's prohibition on fee splitting.[46] As in past years, courts have struggled with whether to give deference to that interpretation.[47] Courts have also addressed various affiliated

40. Real Estate Settlement Procedures Act (RESPA): Home Warranty Companies' Payments to Real Estate Brokers and Agents, 75 Fed. Reg. 36271 (June 25, 2010) (to be codified at 24 C.F.R. pt. 3500).

41. *Id.* at 36272.

42. *Id.*

43. *Id.* at 36272–73.

44. *Id.* at 36273.

45. 12 U.S.C. § 2607(b) (2006); *see*, *e.g.*, John R. Chiles & Zachary D. Miller, *The Long Arm of RESPA: Judicial Expansion of Section 8(b) in 2009*, 64 Consumer Fin. L.Q. Rep. 22 (2010).

46. Real Estate Settlement Procedures Act Statement of Policy 2001-1: Clarification of Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b), 66 Fed. Reg. 53052, 53059 (Oct. 18, 2001) (to be codified at 24 C.F.R. pt. 3500).

47. *See* Elizabeth A. Huber & Dana Frederick Clarke, *2009 Survey of RESPA Developments*, 65 Bus. Law. 555, 565–66 (2009) (in the 2009 *Annual Survey*); Robert M. Jaworski, Joseph M. Kolar & Jonathan W. Cannon, *2008 Survey of RESPA Developments*, 55 Bus. Law. 611, 618–19 (2008) (in the 2008 *Annual Survey*).

business arrangements ("AfBAs") and a number of issues in the context of title insurance when rates are established by a regulator.[48]

One of the most significant RESPA judicial opinions came in the long-running *Carter v. Welles-Bowen Realty, Inc.* litigation.[49] In a June 30, 2010 opinion, the district court granted summary judgment to the defendants in a case alleging violations of RESPA's anti-kickback rule, finding that the defendants' AfBAs complied with RESPA's requirements and holding that HUD's Policy Statement 1996-2—aimed at identifying "sham" AfBAs[50]—was unconstitutionally vague.[51]

In *Carter*, the consumer plaintiffs alleged that the defendants (including a title insurance company and a real estate agency) violated RESPA by setting up sham title insurance companies as conduits for kickbacks.[52] The defendants moved for summary judgment, arguing that the title insurance providers were AfBAs exempt from RESPA's anti-kickback provisions because they: (i) disclosed the ownership arrangement; (ii) did not require the borrowers to use a particular provider; and (iii) compensated their owners based purely on an ownership interest.[53] In response, the plaintiffs argued that the court must also determine whether the entities were sham entities by application of HUD's ten-factor test for distinguishing a "sham" AfBA from a "bona fide provider of settlement services," as set forth in Policy Statement 1996-2.[54]

The defendants argued that HUD's ten-factor test is unconstitutionally vague, and the court—without addressing whether the Policy Statement is entitled to judicial deference—agreed.[55] The court noted that half of the factors in Policy Statement 1996-2 use inherently vague terms (e.g., whether the AfBA has "sufficient" operating capital and net worth, without providing guidance as to what level would be "sufficient").[56] The court also found that the vagueness of the individual factors was "compounded by the subjective balancing process inherent in the test" because the ten factors would be "considered together" to make a final determination.[57] According to the *Carter* court, "[a]ny entity wishing to operate as an [AfBA] (an arrangement RESPA specifically condones, with certain limitations)

48. *See infra* notes 49–59 and accompanying text.

49. No. 3:09 CV 400, 2010 U.S. Dist. LEXIS 64949 (N.D. Ohio June 30, 2010); *see also* Huber & Clarke, *supra* note 47, at 566.

50. Office of the Assistant Secretary for Housing-Federal Housing Commissioner; Real Estate Settlement Procedures Act (RESPA); Statement of Policy 1996-2 Regarding Sham Controlled Business Arrangements, 61 Fed. Reg. 29258 (June 7, 1996) (to be codified at 24 C.F.R. pt. 3500) [hereinafter Policy Statement 1996-2]. Policy Statement 1996-2 sets forth ten factors that HUD considers in determining whether any business venture, set up for the benefit of one or more of its parent entities, is a bona fide service provider under RESPA. *Id.* at 29262. Policy Statement 1996-2 also sets out four additional questions that HUD will consider in determining whether a payment by an AfBA to one or more parents is a return on ownership interest (a statutory requirement under RESPA for the safe harbor exemption) or a prohibited referral fee in violation of section 8(a) of RESPA. *Id.*

51. *Carter*, 2010 U.S. Dist. LEXIS 64949, at *21.

52. *Id.* at *2.

53. *Id.* at *8.

54. *Id.* at *9.

55. *Id.* at *21.

56. *Id.* at *16–17.

57. *Id.*

is thus confronted with a massive gray area [where] [a]t some point . . . both civil and criminal liability might attach."[58] Finding that Policy Statement 1996-2 was void for vagueness, and that the defendants had complied with the AfBA requirements set forth in the statutory text of RESPA, the court granted the defendants' motion for summary judgment.[59]

Courts have continued to address section 8(b) claims in a number of contexts. On March 9, 2010, the U.S. Court of Appeals for the Ninth Circuit affirmed that overcharges do not violate section 8(b).[60] In *Martinez*, the plaintiffs claimed that the defendant bank charged excessive fees for the refinancing of their home mortgage loans and that the overcharges violated RESPA.[61] The court found that "[s]ection 8(b) cannot be read to prohibit charging fees, excessive or otherwise, when those fees are for services that were actually performed."[62] In rejecting HUD's interpretation, the court found that "[s]ection 8(b) is unambiguous and does not extend to overcharges."[63]

Courts also have responded to the decision of the U.S. Court of Appeals for the Second Circuit in *Cohen v. J.P. Morgan Chase & Co.*,[64] in which the court held that section 8(b) liability may be based on the defendant's internal division of a fee into two portions, for one of which it performed no services.[65] A district court in New Jersey implied that *Cohen* was not the rule in the Third Circuit, holding that a recording fee overcharge by a title insurance agency was not actionable under section 8(b).[66]

A U.S. district court in the State of Washington, however, endorsed the holding in *Cohen* in a class-action dispute claiming that a reconveyance fee charged by the defendant violated section 8 because, while the fee consisted of both processing and tracking fees, the defendant did not perform the processing.[67] In *Bushbeck*, the plaintiff borrower refinanced a first-lien and second-lien mortgage loan, and, as part of the transaction, the prior liens were required to be extinguished through a reconveyance.[68] The title insurance company charged the borrower a reconveyance fee consisting of processing and tracking fees.[69] The lender completed the reconveyance and the title insurance company tracked the reconveyances.[70] The borrower alleged, among other things, that the title insurance company collected

58. *Id.* at *17–18.
59. *Id.* at *24.
60. Martinez v. Wells Fargo Home Mortg., Inc., 590 F.3d 549 (9th Cir. 2010).
61. *Id.* at 552.
62. *Id.* at 553–54.
63. *Id.* at 554.
64. 498 F.3d 111 (2d Cir. 2007).
65. *Id.* at 126.
66. *See* Kiley v. NRT Title Agency, LLC, No. 09-3549, 2010 WL 2541627, at *5–6 (D.N.J. June 17, 2010).
67. Bushbeck v. Chi. Title Ins. Co., No. C08-0755, 2010 WL 2262340 (W.D. Wash. June 1, 2010).
68. *Id.* at *10.
69. *Id.* at *2.
70. *Id.* at *3.

an unearned fee in violation of section 8(b) of RESPA.[71] The title insurance company claimed that it did not violate RESPA because it performed some reconveyance services (tracking the reconveyance); thus the fee was earned, and, even if the fee was marked up from its actual cost, RESPA does not apply to overcharges.[72]

The court held that section 8(b) "extends to any portion of the charge for which the service provider does not perform services."[73] Because the title insurance company conceded that the fee disclosed as a "reconveyance" fee on the HUD-1 actually consisted of component parts, and because the title company did not perform any services in connection with one of those component parts, the court denied the defendant's motion for summary judgment on the RESPA claims.[74] The court followed *Cohen* and denied the defendant's motion for summary judgment, noting that the parties agreed that the defendant performed no processing services attributable to the processing fee.[75]

In a section 8(b) case in which the court did not follow *Cohen*, a district court in Louisiana declined to hold a lender and a title insurance and settlement service provider liable for violating section 8(b) after finding that the defendants did not actually split any of the settlement service fees contested by the plaintiff borrowers.[76] In *Freeman*, the borrowers alleged that the defendants violated RESPA and Louisiana law by, among other things: (i) charging a loan discount fee, but failing to provide a corresponding interest rate reduction; and (ii) charging an appraisal fee that was improperly split between the defendants.[77]

In granting summary judgment for the defendants, the court agreed with the defendants that the borrowers' RESPA claims failed as a matter of law because the defendants provided evidence that they did not split or otherwise share the contested loan discount and appraisal fees—instead, the lender received and retained the loan discount fee, and the title insurance and settlement service provider received and retained the appraisal fee.[78] According to the *Freeman* court, section 8(b) of RESPA unambiguously requires "an allegation that the challenged fees have been split in some fashion."[79] The court noted that its decision stands at odds with decisions from the U.S. Courts of Appeals for the Second and Eleventh Circuits, holding that a single service provider can violate section 8(b) of RESPA, but is in line with decisions from the U.S. Courts of Appeals for the Fourth, Seventh, and Eighth Circuits.[80]

The U.S. District Court for the Northern District of Texas, in *Hamilton v. First American Title Insurance Co.*,[81] took the unusual step of certifying a class in a case

71. *Id.*
72. *Id.* at *9.
73. *Id.* at *8.
74. *Id.* at *10.
75. *Id.* at *8, *10.
76. Freeman v. Quicken Loans, Inc., No. 08-1626, 2009 U.S. Dist. LEXIS 69654 (E.D. La. Aug. 10, 2009).
77. *Id.* at *3–4.
78. *Id.* at *9, *64–69.
79. *Id.* at *65.
80. *Id.* at *65–66.
81. 266 F.R.D. 153 (N.D. Tex. 2010).

brought by a group of consumers who alleged that they paid unlawfully excessive premiums for title insurance. In *Hamilton*, the plaintiffs refinanced their mortgage loans and purchased reissued lenders' title insurance policies from the defendant title insurer.[82] The plaintiffs claimed that, although they obtained reissue policies, the defendant charged a higher, original-issue rate.[83] The plaintiffs filed suit, alleging violations of RESPA, along with a number of state-law claims.[84]

The *Hamilton* court, in certifying the class, noted that the analysis of whether damages are warranted would be "straightforward and mechanical."[85] In connection with the RESPA claims, the court noted that there were common questions of law in the plaintiffs' claims, namely, whether HUD's interpretation of RESPA (in which HUD posits that allegedly excessive charges can be bifurcated into "reasonable" and "unreasonable," and therefore unearned and earned, components) is viable, and whether the title company and its agents performed compensable services in connection with any portion of a fee charged in excess of the Texas Department of Insurance's published rates.[86] The court emphasized, however, that in certifying the class on these RESPA claims, it "intimates no view as to the merits of those claims."[87]

Courts also have continued to address a wide variety of other RESPA-related claims. The U.S. Court of Appeals for the Third Circuit weighed in on title insurance in *Alston v. Countrywide Financial Corp.*,[88] in which it reversed the dismissal of a putative class action. In this case, the plaintiff borrowers obtained mortgages from the defendant and were required to obtain private mortgage insurance from insurers that would reinsure their policies with the lender's affiliated reinsurer under a captive reinsurance agreement.[89] According to the borrowers, the captive reinsurance agreement violated RESPA's anti-kickback provisions because it allowed the defendant reinsurer to collect more than $892 million in reinsurance premiums without paying anything in claims.[90] The Third Circuit found that RESPA's plain language did not require the borrowers to allege an "overcharge."[91] According to the court, "the provision of statutory damages based on the entire payment, not on an overcharge, is a certain indication that Congress did not intend to require an overcharge to recover under section 8 of RESPA."[92]

As more borrowers seek loan modifications, there has been an upsurge in related litigation, such as cases arising from QWRs and broker price opinions ("BPOs"). In *Fitch v. Wells Fargo Bank, N.A.*,[93] the court found that a BPO taken in expecta-

82. *Id*. at 157.
83. *Id*.
84. *Id*.
85. *Id*. at 167.
86. *Id*.
87. *Id*. at 169.
88. 585 F.3d 753 (3d Cir. 2009).
89. *Id*. at 756.
90. *Id*. at 757.
91. *Id*. at 759.
92. *Id*. at 760.
93. 709 F. Supp. 2d 510 (E.D. La. 2010).

tion of foreclosure proceedings is not a settlement service; therefore, the plaintiff's RESPA claim was dismissed.[94] In cases in the Ninth Circuit, courts have been careful to parse out the exact alleged violation of RESPA's QWR provisions from complicated fact patterns. The court in *Flores v. GMAC Mortgage Corp*.[95] granted the defendant's motion to dismiss because the bankrupt plaintiff's letter was not a QWR.[96] In *Phillips v. Bank of America Corp*.,[97] the court held that a document that did not allege any financial harm, requested only origination-related documents, and did not allege any servicing errors was not a QWR.[98]

94. *Id*. at 513–16.
95. No. 2:09-cv-01216-GEB-GGH, 2010 WL 582115 (E.D. Cal. Feb. 11, 2010).
96. *Id*. at *4.
97. No. C 10-0400 JF (HRL), 2010 WL 1460824 (N.D. Cal. Apr. 9, 2010).
98. *Id*. at *4.

Fair Lending Developments: Enforcement Comes to the Fore

*By John L. Ropiequet, Christopher S. Naveja, and L. Jean Noonan**

Introduction

The mortgage foreclosure crisis and the change in administration have caused enforcement to take a more prominent role in the fair lending arena. The U.S. Department of Justice ("DOJ") filed three enforcement actions in the past year, including one where some of the targets successfully defended the action, an unusual phenomenon.[1] To further bolster fair lending enforcement, enactment of the Consumer Financial Protection Act ("CFPA")[2] has centralized the investigation and enforcement powers relating to consumer finance in the newly created Bureau of Consumer Financial Protection ("CFPB"). State fair lending enforcement has also been promoted by the provisions of the CFPA.

Private fair lending litigation has been actively pursued against the mortgage finance industry as well. Some litigants appear to be trying to extend fair lending liability beyond mortgage loan originators, the traditional targets, to loan servicers, loan assignees, and other defendants. Most municipal fair lending cases have foundered on the issue of proximate causation.

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* John L. Ropiequet is a partner in the law firm of Arnstein & Lehr LLP in its Chicago office and is a member of the Illinois Bar. He is Pro Bono Liaison of the Committee on Consumer Financial Services of the American Bar Association's Section of Business Law. Christopher S. Naveja is a partner in the law firm of Arnstein & Lehr LLP in its Chicago office and is a member of the Illinois Bar. L. Jean Noonan is a partner in the law firm of Hudson Cook LLP, where she manages the firm's Washington, D.C. office. She is a member of the Maryland Bar.

1. *See* John L. Ropiequet, Christopher S. Naveja & L. Jean Noonan, *Fair Lending Developments: The End of Discretionary Pricing?*, 65 Bus. Law. 571, 579 (2010) (in the 2010 *Annual Survey*) [hereinafter *Fair Lending 2010*].

2. Pub. L. No. 111-203, Title X, 124 Stat. 1376, 1955 (2010) [hereinafter CFPA]. For more on the CFPA, see Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett & Arthur B. Axelson, *Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act*, 66 Bus. Law. 457 (2011) (in this *Annual Survey*) [hereinafter *Mortgage Reform*]; Ralph T. Wutscher & David L. Beam, *The Dodd-Frank Act's New Federalism*, 66 Bus. Law. 519 (2011) (in this *Annual Survey*).

Enforcement Developments

Federal Enforcement

The DOJ's Civil Rights Division brought three enforcement actions in the past year alleging violations of the Equal Credit Opportunity Act ("ECOA")[3] and the Fair Housing Act ("FHA")[4] that focused on misuse of discretionary pricing authority upon referrals from bank regulators. The first case settled racial discrimination claims against First United Security Bank stemming from loans originated in 2004.[5] The complaint alleged that the bank charged African-American borrowers higher interest rates, about sixty-two basis points on average, for conventional first-lien refinance loans than it charged similarly situated white borrowers because it granted loan officers broad discretion to engage in subjective decision making,[6] it discriminatorily redlined through the location of its branches and the placement of its marketing,[7] and it discriminated in the assessment areas it maintained pursuant to the Community Reinvestment Act ("CRA")[8] because it excluded areas with significant minority populations in violation of the CRA and Regulation BB.[9] This resulted in it allegedly receiving many fewer residential mortgage applications for property located in majority-black census tracts than its peers[10] and similar discrimination in its small business loans.[11]

The *First United* settlement requires the bank to invest more than $600,000, open a new branch in an African-American neighborhood, and take other steps to resolve the charges.[12] These include spending at least $110,000 on targeted advertising and marketing to residents and small businesses in majority-black census tracts, establishing a $50,000 fund to pay damages to black mortgage borrowers, and investing $500,000 in a special financing program for residential and small business and community development loans.[13]

In the second case, the DOJ settled claims of racial discrimination against African-American mortgage borrowers by independent mortgage brokers with two

3. Pub. L. No. 93-495, 88 Stat. 1500, 1521 (1974) (codified as amended at 15 U.S.C. §§ 1691–1691f (2006)).

4. Pub. L. No. 90-284, 82 Stat. 81 (1968) (codified as amended at 42 U.S.C. §§ 3601–3631 (2006)).

5. Complaint at 2, United States v. First United Sec. Bank, No. 09-0644 (S.D. Ala. filed Sept. 30, 2009), *available at* http://www.justice.gov/crt/housing/documents/fusbcomp.pdf [hereinafter First United Complaint].

6. *Id.* at 2–3.

7. *Id.* at 4–5.

8. Pub. L. No. 95-128, Title VIII, 91 Stat. 1111, 1147 (1977) (codified as amended at 12 U.S.C.A. §§ 2901–2908 (West 2009)).

9. First United Complaint, *supra* note 5, at 5–6 (citing 12 C.F.R. § 228.41(c)–(e)).

10. *Id.* at 6–7.

11. *Id.* at 7.

12. Agreed Order for Resolution at 6–7, United States v. First United Sec. Bank, No. 09-0644 (S.D. Ala. Nov. 18, 2009), *available at* http://www.justice.gov/crt/housing/documents/fusborderfinal.pdf.

13. *Id.* at 7–17.

subsidiaries of American International Group, Inc. (collectively, "AIG").[14] The complaint alleged that nationwide, black borrowers were charged broker fees twenty basis points higher than white borrowers paid[15] and that in nineteen metropolitan areas, black borrowers paid fees that were twenty-five to seventy-five basis points higher.[16] This allegedly was due to allowing the brokers subjective discretion to set fees, which could not be explained by non-race related factors and were not justified by legitimate business interests.[17]

The *AIG* consent order enjoins AIG from discriminating on the basis of race if it ever re-enters the wholesale mortgage lending business[18] and provides insight into the relief that the DOJ's Civil Rights Division will seek in similar cases. It requires AIG to develop standards for setting broker fees designed to avoid unlawful racial discrimination, with documentation of broker fees to be maintained in each loan file and submitted with the loan application.[19] AIG must require brokers to disclose to applicants their full compensation and whether it is negotiable, and to provide a notice of non-discrimination to each applicant.[20] It must also establish policies that require brokers to comply with these requirements and set up a broker fee monitoring program to detect differences in broker fees by race.[21] AIG must also establish a $6,100,000 settlement fund to pay claims of borrowers identified by the DOJ[22] and must give at least $1,000,000 to qualified organizations to provide financial educational programs targeted at African-American borrowers.[23]

The third DOJ case alleged racial and national origin discrimination against non-Asian auto finance customers by Nara Bank and two dealers from which it purchased retail installment contracts.[24] Although the bank entered into a consent decree,[25] one of the dealers moved to dismiss, and the court dismissed with leave to amend.[26] The DOJ's amended complaint clarified that the borrowers' race or national origin was determined from their names and driver's license photographs

14. Complaint, United States v. AIG Fed. Sav. Bank, No. 10-cv-178-JJF (D. Del. filed Mar. 4, 2010), *available at* http://www.justice.gov/crt/housing/documents/aigcomp.pdf. It had ceased wholesale mortgage lending operations four years before the DOJ filed suit. *Id*. at 2.

15. *Id*. at 4.

16. *Id*.

17. *Id*. at 4–5.

18. Consent Order at 4–5, United States v. AIG Fed. Sav. Bank, No. 10-cv-178-JJF (D. Del. Mar. 19, 2010), *available at* http://www.justice.gov/crt/housing/documents/aigsettle.pdf.

19. *Id*. at 5.

20. *Id*. at 6.

21. *Id*. at 6–7.

22. *Id*. at 10–11.

23. *Id*. at 8.

24. First Amended Complaint, United States v. Nara Bank, No. CV09-7124-RGK (JCx) (C.D. Cal. filed Mar. 18, 2010), *available at* http://www.justice.gov/crt/housing/documents/naracompamend1.pdf [hereinafter Nara Bank Complaint].

25. Partial Consent Decree, United States v. Nara Bank, No. CV09-7124-RGK (JCx) (C.D. Cal. Nov. 18, 2009), *available at* http://www.justice.gov/crt//housing/documents/narapartialsettle.pdf.

26. United States v. Nara Bank, No. CV09-7124-RGK (JCx) (C.D. Cal. Mar. 3, 2010) (Order re: Defendant Han Kook Enterprise's Motion to Dismiss).

and specified the mean overages charged by the dealers.[27] The dealer-defendants then moved to dismiss.

The court granted their motion because the DOJ's disparate impact claim was implausible in two respects. First, the classification of Asians and non-Asians was "vague at best and meaningless at worst."[28] The court questioned how the government classified borrowers with ambiguous names, whether borrowers of Pacific Island descent were counted as Asians or non-Asians, how married couples of different races were classified, and why dealer employees of one Asian nationality would favor Asians of other nationalities.[29] Second, the DOJ's statistical allegations were unpersuasive. For example, the court noted that the amended complaint alleged that half the Asian borrowers from one dealership were treated better than non-Asians, which left open the possibility that the other half were treated worse.[30] The DOJ has appealed.[31]

Bureau of Consumer Financial Protection

Creation of the CFPB will likely change the fair lending enforcement picture at the federal level in important respects. The general power given to the CFPB to conduct joint investigations with other federal agencies includes specific authorization to conduct joint fair lending investigations with the U.S. Department of Housing and Urban Development and the DOJ.[32] The CFPB's investigatory powers cover all "consumer financial laws," defined broadly to include eighteen previously enacted federal statutes[33] plus new CFPA provisions.[34] The CFPB is authorized to enforce consumer financial laws through administrative hearings and in court.[35] It can sue any person who violates those laws,[36] but it must notify the DOJ and the appropriate banking regulators when it does so.[37] The CFPA requires the CFPB and the DOJ to negotiate an agreement to coordinate litigation "to avoid conflicts and promote consistency."[38]

As noted in last year's *Annual Survey*, the Federal Trade Commission ("FTC") has also addressed fair lending problems.[39] The CFPA transfers all consumer finan-

27. Nara Bank Complaint, *supra* note 24, at 7.
28. United States v. Nara Bank, No. CV09-7124-RGK (JCx), 2010 WL 2766992, at *2 (C.D. Cal. May 28, 2010) (Order re: Defendants' Motion to Dismiss the First Amended Complaint).
29. *Id.*
30. *Id.* at *3.
31. United States v. Nara Bank, No. CV09-7124-RGK (JCx), 2010 WL 2766992 (C.D. Cal. May 28, 2010), *appeal docketed sub nom.* United States v. Union Auto Sales, Inc., No. 10-56177 (9th Cir. July 26, 2010).
32. CFPA, *supra* note 2, § 1052(a), 124 Stat. at 2019 (to be codified at 12 U.S.C. § 5562(a)).
33. *Id.* § 1002(12), 124 Stat. at 1957 (to be codified at 12 U.S.C. § 5481(12)). These will include the ECOA but not the FHA.
34. *Id.* § 1002(14), 124 Stat. at 1957 (to be codified at 12 U.S.C. § 5481(14)).
35. *Id.* § 1053(a), 124 Stat. at 2025 (to be codified at 12 U.S.C. § 5563(a)).
36. *Id.* § 1054(a), 124 Stat. at 2028 (to be codified at 12 U.S.C. § 5564(a)).
37. *Id.* § 1054(d)(1), 124 Stat. at 2028 (to be codified at 12 U.S.C. § 5564(d)(1)).
38. *Id.* § 1054(d)(2)(B), 124 Stat. at 2028–29 (to be codified at 12 U.S.C. § 5564(d)(2)(B)).
39. *See Fair Lending 2010*, *supra* note 1, at 577–79.

cial protection functions and authority from many other agencies to the CFPB,[40] but the transfer of authority from the FTC is more limited. Although the FTC's rulemaking and enforcement authority under federal consumer financial laws is transferred to the CFPB, the FTC will retain authority to take action under other laws.[41] Anticipating the potential for conflict, the CFPA directs the two agencies to negotiate an agreement with respect to rulemaking,[42] which may also cause them to divide responsibility for fair lending enforcement.

State Enforcement

Although the CFPA generally centralizes enforcement power in the CFPB, one subtitle preserves or enhances the power of state law enforcement officials,[43] following the U.S. Supreme Court's decision in *Cuomo v. Clearing House Ass'n*.[44] State attorneys general can enforce the CFPA and its regulations,[45] although they cannot sue national banks or federal savings associations unless a federal regulation allows them to do so.[46] They must notify the CFPB before filing suit under the CFPA unless there is an emergency, and the CFPB is empowered to intervene and remove such actions to federal court.[47] If state officials sue solely under state law, their authority is not to be construed as being altered, limited, or affected by the CFPA.[48]

The CFPA also reverses the U.S. Supreme Court's decision in *Watters v. Wachovia Bank, N.A.*[49] State consumer financial laws, including fair lending laws, will apply to any subsidiary or affiliate of a national bank that is not itself chartered as a national bank.[50] In addition, the CFPA provides that nothing in it or in the Federal Reserve Act[51] is to be construed as "preempting, annulling, or affecting the

40. CFPA, *supra* note 2, § 1061(b)(1)–(4), (6)–(7), 124 Stat. at 2036–38 (to be codified at 12 U.S.C. § 5581(b)(1)–(4), (6)–(7)).

41. *Id.* § 1061(b)(5)(A)–(C), 124 Stat. at 2036–37 (to be codified at 12 U.S.C. § 5581(b)(5)(A)–(C)). For example, the FTC could still bring fair lending actions under the FHA. *See supra* note 33.

42. CFPA, *supra* note 2, § 1061(b)(5)(D), 124 Stat. at 2037 (to be codified at 12 U.S.C. § 5582(b)(5)(D)).

43. *Id.* §§ 1041–1047, 124 Stat. at 2011–18 (to be codified at 12 U.S.C. §§ 25b, 1465, 5551–5553).

44. 129 S. Ct. 2710 (2009); *see Fair Lending 2010*, *supra* note 1, at 579–80; David L. Beam & Ralph T. Wutscher, *The New Trajectory of Federal Preemption*, 65 Bus. Law. 645, 646–50 (2010) (in the 2010 *Annual Survey*).

45. CFPA, *supra* note 2, § 1042(a)(1), 124 Stat. at 2012 (to be codified at 12 U.S.C. § 5552(a)(1)).

46. *Id.* § 1042(a)(2), 124 Stat. at 2013 (to be codified at 12 U.S.C. § 5552(a)(2)).

47. *Id.* § 1042(b), 124 Stat. at 2013 (to be codified at 12 U.S.C. § 5552(b)).

48. *Id.* § 1042(d), 124 Stat. at 2014 (to be codified at 12 U.S.C. § 5552(d)).

49. 550 U.S. 1 (2006); *see* John L. Ropiequet, Nathan O. Lundby, Kenneth J. Rojc & Sara B. Lubezny, *Update on ECOA and Fair Lending Developments*, 63 Bus. Law. 663, 669 (2008) (in the 2008 *Annual Survey*) [hereinafter *Fair Lending 2008*]; Michael C. Tomkies, Ralph T. Wutscher & Elizabeth L. Anstaett, *Preemption and Federalism Developments:* Watters *Under the Bridge*, 63 Bus. Law. 703 (2008) (in the 2008 *Annual Survey*).

50. CFPA, *supra* note 2, § 1044, 124 Stat. at 2016–17 (to be codified at 12 U.S.C. § 25b(e)).

51. Act of Dec. 23, 1913, ch. 6, 38 Stat. 251 (1913) (codified as amended at 12 U.S.C. §§ 221–522 (2006)).

applicability of State law" to such subsidiaries or affiliates.[52] The same standard also applies to federal savings associations.[53]

The CFPA also reinforces the *Cuomo* decision by codifying the Supreme Court's ruling on visitorial powers. It amends the National Bank Act to provide that visitorial powers will not be construed as "limiting or restricting the authority of any attorney general (or any chief law enforcement officer) of any State to bring an action against a national bank" to enforce state laws.[54] The same is true for visitorial powers over federal savings associations.[55]

As noted in the previous *Annual Survey*,[56] the Illinois Attorney General filed an enforcement action alleging that Wells Fargo, a national bank, and two of its subsidiaries violated state fair lending and consumer protection laws.[57] A similar complaint has been filed against Countrywide Financial Corporation and two of its subsidiaries.[58] The complaint alleged that Countrywide also violated state fair lending laws by engaging in discriminatory steering of African-American and Latino borrowers to high cost loans, resulting in both a disparate impact and disparate treatment.[59] As in *Wells Fargo*, pricing discretion and financial incentives given to loan officers and mortgage brokers without sufficient management controls allegedly led to racial discrimination.[60] Targeting of minority borrowers through marketing campaigns also allegedly contributed to the discriminatory effects of the discretionary pricing policies.[61]

Litigation Developments

Private Discrimination Claims

Over the past few years, several reported cases have included allegations of reverse redlining, the alleged practice of intentionally targeting minority borrowers for higher cost loans, as a basis for discrimination claims.[62] Such claims have

52. CFPA, *supra* note 2, § 1045, 124 Stat. at 2017 (to be codified at 12 U.S.C. § 25b(h)(2)).

53. *Id.* § 1046, 124 Stat. at 2017–18 (to be codified at 12 U.S.C. § 1465).

54. *Id.* § 1047(a), 124 Stat. at 2018 (to be codified at 12 U.S.C. § 25b(i)(1)).

55. *Id.* § 1047(b), 124 Stat. at 2018 (to be codified at 12 U.S.C. § 1465(c)).

56. *See Fair Lending 2010*, *supra* note 1, at 580 n.100.

57. *See* Complaint, People v. Wells Fargo & Co., No. 09 CH 26434 (Ill. Cir. Ct. filed July 31, 2009), *available at* http://www.illinoisattorneygeneral.gov/pressroom/2009_07/WELLS%20FARGO%20COMPLAINT_07-31-2009_13-44-30.pdf [hereinafter Wells Fargo Complaint]. As of this writing, the bank has moved to dismiss and no decision date has been set.

58. *See* Complaint, People v. Countrywide Fin. Corp., No. 10 CH 27929 (Ill. Cir. Ct. filed June 29, 2010), *available at* http://www.illinoisattorneygeneral.gov/pressroom/2010_06/COUNTRYWIDE_COMPLAINT_4_INJUNCTIVE__OTHER_RELIEF_06-29-2010_16-20-51.pdf [hereinafter Countrywide Complaint].

59. *Id.* at 2–3.

60. *Id.* at 11–23; *cf*. Wells Fargo Complaint, *supra* note 57, at 16–25.

61. Countrywide Complaint, *supra* note 58, at 25–26. As of this writing, the defendants tried unsuccessfully to remove the case to federal court. *See* Petition for Removal, People v. Countrywide Fin. Corp., No. 1:10-cv-5416 (N.D. Ill. Aug. 26, 2010). The district court promptly dismissed the case sua sponte. People v. Countrywide Fin. Corp., No. 1:10-cv-5416 (N.D. Ill. Aug. 30, 2010) (minute entry).

62. *See Fair Lending 2010*, *supra* note 1, at 574–75.

begun to be asserted more recently against mortgage loan servicers, loan assignees, and others besides loan originators.

In *Rodriguez v. Bear Stearns Cos.*,[63] for example, the plaintiffs alleged that the predatory lending practices of a loan servicer, EMC Mortgage, constituted intentional racial discrimination with a disparate impact on minorities in violation of the FHA. The *Rodriguez* court held that in order to prevail on their FHA claim, the plaintiffs must "demonstrate that an outwardly neutral practice actually or predictably has a discriminatory effect."[64] The plaintiffs alleged that EMC followed a general policy of servicing non-prime loans differently than prime loans despite a stated policy to the contrary, but the court found that the policy was not identified with sufficient particularity to sustain a discriminatory impact claim.[65] Moreover, despite acknowledging that "statistical proof almost always occupies center stage in a *prima facie* showing of a disparate impact claim," the plaintiffs offered no statistical evidence whatsoever.[66] The court therefore granted summary judgment dismissing their claims.[67]

In *Levey v. CitiMortgage, Inc.*,[68] the plaintiffs alleged violations of the FHA and the ECOA by CitiMortgage as the assignee of the plaintiffs' loan. The plaintiffs' allegations of misconduct centered around the events leading up to the origination of the loan, but did not allege any discriminatory conduct by the assignee.[69] Since CitiMortgage never made a loan to the plaintiffs, the court found that no claim was stated for discrimination in the sale of a dwelling under section 3604(a) of the FHA.[70] Likewise, there was no basis for a section 3605(a) violation since there was no discrimination in the sale or transfer of a mortgage loan.[71] As to the ECOA claim, the *Levey* court noted that an assignee can be held liable for the acts of another party as a "creditor" if the assignee "participated in" the decision to extend credit or, under Regulation B, knew of the discriminatory practice before becoming involved in the transaction.[72] But, since the plaintiffs did not allege that CitiMortgage participated in the underlying extension of credit, there was nothing to support ECOA liability.[73] Also, longitudinal studies showing racial differentials in rates of foreclosure and mortgage terms offered to Chicago residents were "too

63. No. 07-cv-1816-JCH, 2009 U.S. Dist. LEXIS 119942 (D. Conn. Dec. 22, 2009). An earlier decision in the case was discussed in *Fair Lending 2010*, *supra* note 1, at 574–75.

64. *Rodriguez*, 2009 U.S. Dist. LEXIS 119942, at *18.

65. *Id.* at *21.

66. *Id.* at *36–39. The court noted that claims of reverse redlining and predatory lending are "consistently" denied where no statistical evidence is offered by plaintiffs. *Id.* at *50–51.

67. *Id.* at *58.

68. No. 07 C 2678, 2009 U.S. Dist. LEXIS 70210 (N.D. Ill. Aug. 10, 2009).

69. *Id.* at *5.

70. *Id.* at *5–6 (citing 42 U.S.C. § 3604(b)).

71. *Id.* at *7–8 (citing 42 U.S.C. § 3605(a)).

72. *Id.* at *8 (citing 12 C.F.R. § 202.2(*l*)); *see* John L. Ropiequet & Nathan O. Lundby, *Dealer Rate Participation Class Actions Under the ECOA: Have We Reached the End of the Road?*, 62 Bus. Law. 663, 666 (2007) (in the 2007 *Annual Survey*).

73. *Levey*, 2009 U.S. Dist. LEXIS 70210, at *8–9.

general" to notify CitiMortgage of any wrongdoing at the time of mortgage origination.[74] The court therefore dismissed the ECOA claim as well.[75]

In *Swanson v. Citi*,[76] the plaintiffs alleged that Citibank and its appraiser intentionally discriminated against African-Americans by discouraging them from applying for loans and obtaining undervalued appraisals to provide a purportedly legitimate reason to deny conditionally approved loans.[77] The court found that there were no allegations that Citibank was approving loans for non-minority applicants with qualifications similar to those of the plaintiffs, a required element under both statutes.[78] The plaintiffs argued that a discrepancy between the value in Citibank's appraisal and the value in an appraisal by another appraiser they hired showed that their claims met the plausibility standard of *Ashcroft v. Iqbal*.[79] However, the court held that a mere disparity between appraisals does not create an inference of discrimination, and it dismissed the plaintiffs' FHA and ECOA claims.[80]

The Seventh Circuit reversed, finding that the Supreme Court had not tossed Federal Rule 8(a)(2) out the window in *Iqbal* and earlier decisions, but changed the standard from what "*might* suggest that something has happened to [the plaintiffs] that *might* be redressed by the law" to a fair notice standard that requires a court to "ask itself *could* these things have happened, not *did* they happen" under the allegations of the complaint.[81] Since the plaintiffs had alleged what type of discrimination occurred, by whom, and when, it held that an FHA discrimination claim was properly stated against both the bank and its appraiser.[82]

Municipal Discrimination Claims

Last year's *Annual Survey* reported on fair lending cases brought by some municipalities on reverse redlining theories in response to the mortgage foreclosure crisis.[83] After one of the cases, *Mayor & City Council of Baltimore v. Wells Fargo Bank, N.A.*,[84] survived a motion to dismiss,[85] the city amended and the bank moved to dismiss based in part on a decision that dismissed a very similar case filed by the City of Birmingham.[86] In granting the bank's motion to dismiss, the *Baltimore*

74. *Id.* at *11–13.

75. *Id.* at *14.

76. 706 F. Supp. 2d 854 (N.D. Ill. 2009), *rev'd in part sub nom.* Swanson v. Citibank, N.A., 614 F.3d 400 (7th Cir. 2010).

77. *Id.* at 857.

78. *Id.* at 859.

79. *Id.* at 860 (citing Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009)).

80. *Id.*

81. *Swanson*, 614 F.3d at 403–04.

82. *Id.* at 405–06. The ECOA claim was abandoned on appeal.

83. *See* Richard E. Gottlieb & Brett J. Natarelli, *Update on Municipal Nuisance and Discrimination Litigation*, 65 Bus. Law. 665 (2010) (in the 2010 *Annual Survey*) [hereinafter *Municipal Nuisance*]; *Fair Lending 2010*, *supra* note 1, at 574.

84. 631 F. Supp. 2d 702 (D. Md. 2009).

85. *See Municipal Nuisance*, *supra* note 83, at 670.

86. City of Birmingham v. Citigroup, Inc., No. CV-09-BE-467-S, 2009 U.S. Dist. LEXIS 123123 (N.D. Ala. Mar. 12, 2009) (granting motion to dismiss); *see Municipal Nuisance*, *supra* note 83, at 671.

court held that the city failed to allege that it suffered a "concrete and particularized, and actual or imminent" injury that was causally connected to the alleged reverse redlining, or that "it is likely, as opposed to merely speculative, that the injury will be redressed by a favorable decision of the court."[87] Noting that the city's amended complaint alleged that out of an estimated 16,000 to 33,000 vacant homes in the city, only 401 homes were foreclosed on by the defendant bank, of which only 163 were in African-American neighborhoods and only eighty of which were vacant, the court found that "too much speculation is required to connect the causal links" because the claimed injuries were "too indirect," having resulted from the actions of independent parties.[88] Where only a "negligible portion" of the city's vacant homes could be tied to the bank's conduct, the claims were not plausible.[89]

The city amended, but its complaint was dismissed again.[90] Although the city had cured a "fundamental flaw" concerning causation "by focusing upon 'property specific,' rather than generalized, damages," there remained another flaw since the city's claims were based on the allegation that improper loan practices caused the foreclosed properties to become vacant.[91] The causal link would still be broken for subprime loans made to borrowers whose credit ratings "would not have permitted them to obtain a loan at all."[92] The *Baltimore* court found that the city failed to allege that specific properties were occupied prior to sales "facilitated by the 'bad' Wells Fargo loans" and would have remained occupied but for those loans, but it reluctantly granted leave to amend once more if the city could make such allegations in good faith.[93]

Conclusion

As noted in the previous *Annual Survey*,[94] most reported fair lending decisions give little or no guidance on what really constitutes evidence of disparate impact on protected minorities and what evidence can be used to counter statistical evidence collected under the Home Mortgage Disclosure Act[95] and Regulation C[96] that shows a disparity between treatment of minority and non-minority borrow-

87. Mayor & City Council of Balt. v. Wells Fargo Bank, N.A., 677 F. Supp. 2d 847, 849 (D. Md. 2010).
88. *Id*. at 849–50.
89. *Id*. at 850 (citing Ashcroft v. Iqbal, 129 S. Ct. 1937, 1949 (2009)).
90. Mayor & City Council of Balt. v. Wells Fargo Bank, N.A., No. 08 CV 62 (D. Md. Sept. 14, 2010) (memo to counsel), *available at* http://dockets.justia.com/docket/maryland/mddce/1:2008cv00062/155559/. While this document is fashioned as an informal letter to counsel, the court provided that "it should be flagged as an opinion and docketed as an order." *Id*. at 2.
91. *Id*. at 1.
92. *Id*.
93. *Id*. at 1–2 (emphasis omitted).
94. *See Fair Lending 2010, supra* note 1, at 581.
95. Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, 89 Stat. 1125 (codified at 12 U.S.C. §§ 2801–2810 (2006)); *see Fair Lending 2008*, *supra* note 49, at 666–67.
96. *See* 12 C.F.R. pt. 203 (2010).

ers. However, a few cases that have reached summary judgment shed some light on this difficult question.

Federal fair lending enforcement actions by both the DOJ and the CFPB are likely to become more numerous.[97] Additional consent decrees can be expected to result. On the other hand, the substantive provisions of Title XIV of the Dodd-Frank Act,[98] which are designed to curb abuses in connection with mortgage loan origination, may operate to diminish the root causes that have motivated many fair lending cases.

State fair lending enforcement initiatives have been surprisingly sparse following the Supreme Court's decision in *Cuomo*. The CFPA may perhaps encourage state officials to pursue fair lending enforcement, although the statistics-heavy nature of such actions may tend to discourage them, given the prosecutorial resources needed. The targeted financial institutions have successfully defended municipal fair lending cases, which seem likely to end.

The number of reported private fair lending decisions appears to be diminishing. This may be a reflection of severe attrition among mortgage lenders and brokers who have not survived the financial crisis. Efforts to expand the pool of potential defendants by making fair lending claims against persons who were not involved with mortgage loan origination may be a new trend, but it is too early to tell whether such claims will succeed. The courts are taking a harder look at FHA and ECOA discrimination claims under *Iqbal* and other recent decisions, so defendants may have more success at the pleadings stage than loan originators have had in the past.[99]

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97. *See, e.g.*, Press Release, U.S. Dep't of Justice, Attorney General Eric Holder Speaks at the Financial Fraud Enforcement Task Force Press Conference (Nov. 17, 2009), *available at* http://www.justice.gov/ag/speeches/2009/ag-speech-091117.html.

98. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. XIV, 124 Stat. 1376, 2136 (2010). The provisions of Title XIV are discussed in detail in *Mortgage Reform*, *supra* note 2, at 466–472.

99. *See Fair Lending 2010*, *supra* note 1, at 572–75; John L. Ropiequet & L. Jean Noonan, *Recent Developments in Fair Lending: The Dawn of a New Litigation Era?*, 64 Bus. Law. 563, 564–74 (2009) (in the 2009 *Annual Survey*).

Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act

*By Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett, and Arthur B. Axelson**

Introduction

On July 21, 2010, President Barack Obama signed into law landmark financial reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[1] The Dodd-Frank Act, which was passed in response to the financial meltdown of 2008–2009,[2] is the culmination of recent efforts to overhaul the United States financial regulatory system, and it represents a paradigm shift in the regulation of financial services. This survey discusses the new consumer protection agency (Title X) and mortgage reforms (Title XIV) contained in the Dodd-Frank Act.

Title X—Consumer Financial Protection Act

Title X of the Dodd-Frank Act, the Consumer Financial Protection Act of 2010 ("CFPA"),[3] creates the Bureau of Consumer Financial Protection (the "CFPB") and empowers it to enforce existing and new federal consumer financial laws.[4] The discussion immediately below reviews the creation, scope, management, funding, powers, and activities of the CFPB. The CFPA also materially changes the standards and procedures that federal regulators and courts apply when determining

* Julie R. Caggiano is General Counsel of Envoy Mortgage, headquartered in Houston, Texas, and is Chair of the Membership Committee of the American Bar Association Section of Business Law. Jennifer L. Dozier is an associate at Franzén and Salzano in Atlanta, Georgia. Richard P. Hackett is a partner with the firm of Pierce Atwood LLP in Portland, Maine, and is Vice Chair of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law. Arthur B. Axelson is head of the Financial Services Regulatory and Compliance Practice at the Dykema firm in Washington, D.C.

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

2. *See generally* Julie R. Caggiano, Therese G. Franzén & Jennifer L. Dozier, *Developments in State and Federal Mortgage Lending Laws: Predatory Lending and Beyond*, 65 Bus. Law. 583 (2010) (in the 2010 *Annual Survey*).

3. Dodd-Frank Act, *supra* note 1, tit. X, §§ 1001–1100H, 124 Stat. at 1955–2113.

4. *Id.* § 1022, 124 Stat. at 1980 (to be codified at 12 U.S.C. § 5512).

whether a state consumer financial law[5] applies to a national bank or a federally chartered thrift. Those new rules are discussed separately in this *Annual Survey*.[6]

The CFPB has broad powers over "covered persons,"[7] a term that includes those who offer or provide a "financial product or service,"[8] and may also reach, under certain circumstances, their "service providers"[9] and "related persons."[10] The definition of each of these terms subsumes a complex set of covered financial activities and actors, together with partial or complete exemptions for certain industry segments and activities. In addition, section 1027 of the CFPA enumerates additional complete or partial exemptions for certain financial service providers, as noted below.

A "financial product or service" includes consumer credit (extending, servicing, acquiring, purchasing, selling, or brokering);[11] consumer leasing;[12] real estate settlement services and appraisals of real and personal property;[13] deposit taking and money transmitting;[14] stored value (selling, providing, and issuing, with exceptions);[15] checks (cashing, collecting, guaranteeing);[16] financial data processing;[17] financial advisory services, including credit counseling, debt man-

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5. *See id.* § 1044(a), 124 Stat. at 2014–15 (to be codified at 12 U.S.C. § 25b) (defining "state consumer financial laws").

6. *See* Ralph T. Wutscher & David L. Beam, *The Dodd-Frank Act's New Federalism*, 66 Bus. Law. 519 (2011) (in this *Annual Survey*); *see also* Matthew Dyckman, Matthew S. Yoon & John P. Holahan, *Financial Regulatory Reform—The Dodd-Frank Act Rolls Back Federal Preemption*, 64 Consumer Fin. L.Q. Rep. 129 (2010).

7. Dodd-Frank Act, *supra* note 1, § 1002(6), 124 Stat. at 1956 (to be codified at 12 U.S.C. § 5481(6)).

8. *Id.*; *see also id.* § 1002(15)(A), 124 Stat. at 1957–58 (to be codified at 12 U.S.C. § 5481(15)(A)) (defining "financial product or service").

9. *Id.* § 1002(26), 124 Stat. at 1962–63 (to be codified at 12 U.S.C. § 5481(26)).

10. *Id.* § 1002(25), 124 Stat. at 1962 (to be codified at 12 U.S.C. § 5481(25)).

11. *Id.* § 1002(15)(A)(i), 124 Stat. at 1957–58 (to be codified at 12 U.S.C. § 5481(15)(A)(i)) (the definition excludes "solely extending commercial credit to a person who originates consumer credit transactions").

12. *Id.* § 1002(15)(A)(ii), 124 Stat. at 1958 (to be codified at 12 U.S.C. § 5481(15)(A)(ii)). This includes

> extending or brokering leases of personal or real property that are the functional equivalent of purchase finance arrangements, if—(I) the lease is on a non-operating basis; (II) the initial term of the lease is at least 90 days; and (III) . . . [with regard to real property], at the inception of the initial lease, the transaction is intended to result in ownership of the leased property to be transferred to the lessee.

Id.

13. *Id.* § 1002(15)(A)(iii), 124 Stat. at 1958 (to be codified at 12 U.S.C. § 5481(15)(A)(iii)).

14. *Id.* § 1002(15)(A)(iv), 124 Stat. at 1958 (to be codified at 12 U.S.C. § 5481(15)(A)(iv)). This section includes "otherwise acting as a custodian of funds or any financial instrument for use by or on behalf of a consumer." *Id.* "Transmitting or exchanging funds" is further defined very broadly in section 1002(29), 124 Stat. at 1964 (to be codified at 12 U.S.C. § 5481(29)).

15. *Id.* § 1002(15)(A)(v), 124 Stat. at 1958 (to be codified at 12 U.S.C. § 5481(15)(A)(v)). The exceptions are for (i) "a seller [that] is not a party to the contract with the consumer for the stored value product, [if] another person is principally responsible for establishing the terms and conditions"; and (ii) "advertising the nonfinancial goods and services of the seller on the stored value card or device." *Id.* "Stored value" is further defined in the Dodd-Frank Act in section 1002(28), again in a very broad fashion. *Id.* § 1002(28), 124 Stat. at 1963–64 (to be codified at 12 U.S.C. § 5481(28)).

16. *Id.* § 1002(15)(A)(vi), 124 Stat. at 1958 (to be codified at 12 U.S.C. § 5481(15)(A)(vi)).

17. *Id.* § 1002(15)(A)(vii), 124 Stat. at 1958–59 (to be codified at 12 U.S.C. § 5481(15)(A)(vii)). This excludes retail transaction data capture and persons who "provide[] access to a host server to a person for purposes of enabling that person to establish and maintain a website." *Id.*

agement, and debt settlement;[18] consumer reporting ("collecting, analyzing, maintaining, or providing," with exceptions);[19] debt collection (if related to a consumer financial product);[20] and any other financial product or service defined by rule issued by the CFPB.[21]

To be covered, the financial product or service must be offered or provided for use by consumers primarily for personal, family, or household use, except that the offering of credit-related services, settlement services, consumer reporting, or debt collection between businesses is covered, if the underlying product is offered to consumers.[22]

In addition to the limitations and exclusions noted above, the term "financial product or service" expressly excludes the business of insurance and electronic conduit services.[23]

Offering or providing any of the foregoing financial products or services will make the person a "covered person" subject to CFPB jurisdiction. Under some circumstances, that jurisdiction also reaches a vendor to or a related person of a "covered person." Vendors are subject to CFPB examination and enforcement powers as "service providers" if they provide a "material service," including participating in the design, operation, or maintenance of a consumer financial product or service or processing transactions relating to the product or service.[24]

Given the very broad reach of the CFPB described above, some industries and professions that interact with consumers or support the financial services industry obtained exclusions of varying degrees and scope, which are collected in section

18. *Id.* § 1002(15)(A)(viii), 124 Stat. at 1959 (to be codified at 12 U.S.C. § 5481(15)(A)(viii)). This excludes SEC-regulated persons or persons regulated by a state securities commission. *Id.*

19. *Id.* § 1002(15)(A)(ix), 124 Stat. at 1959–60 (to be codified at 12 U.S.C. § 5481(15)(A)(ix)). There are exceptions for persons who: (i) use information that relates solely to the transaction between a consumer and such person; (ii) provide such information to an affiliate; or (iii) provide such information for non-consumer financial products and services such as employment, residential leases, etc. *Id.*

20. *Id.* § 1002(15)(A)(x), 124 Stat. at 1960 (to be codified at 12 U.S.C. § 5481(15)(A)(x)). *Id.*

21. Dodd-Frank Act, *supra* note 1, § 1002(15)(A)(xi), 124 Stat. at 1960 (to be codified at 12 U.S.C. § 5481(15)(A)(xi)). The CFPB must find that such a product or service is "(I) entered into . . . to evade any Federal consumer financial law; or (II) permissible for a bank or for a financial holding company to offer . . . and has, or is likely to have, a material impact on consumers." *Id.* The following activities are excluded from this "catch-all" provision: (i) identity authentication; (ii) fraud or identity theft detection, prevention, and investigation; (iii) document retrieval and delivery; (iv) public information records information retrieval; and (v) anti-money laundering products or services. *Id.* § 1002(15)(B)(i), 124 Stat. at 1960 (to be codified at 12 U.S.C. § 5481(15)(B)).

22. *Id.* § 1002(5)(B), 124 Stat. at 1956 (to be codified at 12 U.S.C. § 5481(5)(B)).

23. *Id.* § 1002(15)(C), 124 Stat. at 1960 (to be codified at 12 U.S.C. § 5481(15)(C)). These terms are in turn defined in the Dodd-Frank Act in section 1002(3), 124 Stat. at 1955 (to be codified at 12 U.S.C. § 5481(3)) ("business of insurance"), and 1002(11), 124 Stat. at 1956–57 (to be codified at 12 U.S.C. § 5481(11)) ("electronic conduit services"). The latter is intended to exclude those who provide data transmission and storage generally, without modifying the content and without differentiating between financial data and other data (i.e., content-neutral data systems). *Id.* § 1002(11).

24. *Id.* § 1002(26), 124 Stat. at 1963 (to be codified at 12 U.S.C. § 5481(26)). But the term excludes (i) support services generally provided to businesses or of a ministerial nature; and (ii) advertisers of consumer financial products or services. *Id.*

1027 of the CFPA. With the notable exception of automobile dealers,[25] the exclusions do not apply to CFPB rulemaking under the "enumerated consumer laws" nor to the enforcement of those rules by either the Federal Trade Commission ("FTC") or the CFPB.[26] The following persons are generally excluded from the enforcement, examination, supervision, and rulemaking authority of the CFPB: (i) merchants, retailers, or sellers of any non-financial good or services who do not offer financial products or services,[27] together with credit-sellers who: (a) extend credit directly to a consumer in order to enable the consumer to purchase a non-financial good or service; (b) directly, or through an agreement with a third party, collect debt arising from credit extended as indicated above; or (c) sell or convey debt described above that is delinquent or otherwise in default;[28] (ii) licensed real estate brokers;[29] (iii) manufactured home retailers and modular home retailers;[30] (iv) accountants and tax preparers;[31] (v) lawyers;[32] (vi) persons subject to regulation by a state insurance regulator;[33] (vii) employee benefit and compensation plans;[34] (viii) persons regulated by a state securities commission;[35] (ix) persons

25. *Id.* § 1029, 124 Stat. at 2004–05 (to be codified at 12 U.S.C. § 5519). This section excludes those engaged in the sale, servicing, and leasing of motor vehicles from any CFPB jurisdiction. *Id.*

26. *Id.* § 1027(a)(1), 124 Stat. at 1995 (to be codified at 12 U.S.C. § 5517(a)(1)).

27. *Id.*

28. *Id.* § 1027(a)(2)(A), 124 Stat. at 1995 (to be codified at 12 U.S.C. § 5517(a)(2)(A)). This exclusion does not apply if: (i) "the person assigns, sells, or otherwise conveys" non-delinquent debt; (ii) "the credit extended significantly exceeds the market value of the nonfinancial good or service provided"; or (iii) the person "regularly extends [such] credit and the credit is subject to a finance charge." *Id.* § 1027(a)(2)(B), 124 Stat. at 1995–96 (to be codified at 12 U.S.C. § 5517(a)(2)(B)). Notwithstanding the foregoing, the exclusion does apply to a person described in clause (iii) above, unless the person is engaged "significantly" in offering or providing consumer financial products or services. *Id.* § 1027(a)(2)(C), 124 Stat. at 1996 (to be codified at 12 U.S.C. § 5517(a)(2)(C)). Last, notwithstanding all of the above, a merchant, retailer, or seller who meets the small business threshold defined in section 3 of the Small Business Act is excluded from coverage under the CFPA, as long as that merchant, retailer, or seller extends credit only for the sale of non-financial goods and services and retains such credit on its own accounts (except to sell or convey delinquent debt). *Id.* § 1027(a)(2)(D)(ii), 124 Stat. at 1996 (to be codified at 12 U.S.C. § 5517(a)(2)(D)(ii)). None of the exclusions apply to the CFPB's role in enforcement of and rulemaking under the enumerated consumer laws (such as the Truth in Lending Act). *See supra* note 26.

29. Dodd-Frank Act, *supra* note 1, § 1027(b), 124 Stat. at 1997 (to be codified at 12 U.S.C. § 5517(b)). This is limited to brokerage of real property and negotiating any portion of a real estate contract (sale, purchase, lease, rental, or exchange). *Id.*

30. *Id.* § 1027(c), 124 Stat. at 1997–98 (to be codified at 12 U.S.C. § 5517(c)). This is similar to the limitation for real estate brokers.

31. *Id.* § 1027(d), 124 Stat. at 1998–99 (to be codified at 12 U.S.C. § 5517(d)). This is limited to "customary and usual" accounting activity. *Id.*

32. *Id.* § 1027(e), 124 Stat. at 1999 (to be codified at 12 U.S.C. § 5517(e)) (for services "offered, or provided as part of, or incidental to, the practice of law, occurring exclusively within the scope of the attorney-client relationship").

33. *Id.* § 1027(f), 124 Stat. at 2000 (to be codified at 12 U.S.C. § 5517(f)). This excludes people who offer or provide consumer financial products or services. *Id.*

34. *Id.* § 1027(g), 124 Stat. at 2000–01 (to be codified at 12 U.S.C. § 5517(g)). This includes plans described in sections 220, 223, 401(a), 403(a), 403(b), 408, 408A, 529, or 530 of the Internal Revenue Code, or any employee benefit or compensation plan, including any plan subject to Title I of the Employee Retirement Income Security Act or any prepaid tuition program offered by a state. *Id.*

35. *Id.* § 1027(h), 124 Stat. at 2001–02 (to be codified at 12 U.S.C. § 5517(h)). This excludes people who offer or provide consumer financial products or services. *Id.*

regulated by the U.S. Securities and Exchange Commission ("SEC") and Commodities Futures Trading Commission ("CFTC");[36] (x) persons regulated by the Farm Credit Administration;[37] and (xi) charitable fundraising.[38]

A final, critical definition in describing the scope of CFPB authority is the "enumerated consumer laws" or "ECLs."[39] The CFPB receives exclusive rulemaking authority under these laws[40] and has exclusive[41] or shared[42] enforcement authority under them. The ECLs essentially include every federal consumer financial protection law enacted since the Truth in Lending Act in 1968,[43] with the notable exception of the Community Reinvestment Act ("CRA").[44]

Powers, Responsibilities, and Functions of the CFPB: Regulation, Supervision, and Enforcement

Purposes

The primary purpose of the CFPB is to ensure that all consumers have access to consumer financial products and services that are "fair, transparent, and competitive."[45] This objective is to be carried out through the promulgation of

36. *Id.* § 1027(i), (j), 124 Stat. at 2002 (to be codified at 12 U.S.C. § 5517(i), (j)). The SEC and CFTC are directed to consult and coordinate with the CFPB with respect to any product or service that competes with a consumer financial product or service. *Id.*

37. *Id.* § 1027(k), 124 Stat. at 2002 (to be codified at 12 U.S.C. § 5517(k)).

38. *Id.* § 1027(*l*), 124 Stat. at 2002–03 (to be codified at 12 U.S.C. § 5517(*l*)). This excludes people who offer or provide consumer financial products or services. *Id.*

39. "Enumerated consumer laws" include the following: Alternative Mortgage Transaction Parity Act; Consumer Leasing Act; Electronic Fund Transfer Act (except § 920, which stays with the Federal Reserve Board); Equal Credit Opportunity Act; Fair Credit Billing Act; Fair Credit Reporting Act (except §§ 615(a) and 628); Home Owners Protection Act; Fair Debt Collection Practices Act; Federal Deposit Insurance Act (§ 43(b)–43(f) only); Gramm-Leach-Bliley Act (§§ 502–509 only, except § 505 as it applies to § 501(b)); Home Mortgage Disclosure Act; Home Ownership and Equity Protection Act; Real Estate Settlement Procedures Act; SAFE Mortgage Licensing Act; Truth in Lending Act; Truth in Savings Act; Omnibus Appropriations Act (§ 626 only); and Interstate Land Sales Full Disclosure Act. *Id.* § 1002(12), 124 Stat. at 1957 (to be codified at 12 U.S.C. § 5481(12)).

40. *Id.* § 1022(b)(4), 124 Stat. at 1981 (to be codified at 12 U.S.C. § 5512(b)(4)).

41. With respect to "large" depository institutions, the CFPB has exclusive examination and enforcement authority for the ECLs; with respect to smaller institutions, the CFPB has limited examination authority and no enforcement authority for the ECLs. *Id.* §§ 1025, 1026, 124 Stat. at 1990–95, 1993 (to be codified at 12 U.S.C. §§ 5515, 5516).

42. With respect to nonbanks (except auto dealers), the CFPB has exclusive rulemaking authority, and it also has examination, supervision, and licensing authority over specified nonbanks. *Id.* § 1024, 124 Stat. at 1987 (to be codified at 12 U.S.C. § 5514); *see also infra* notes 65–70 and accompanying text. The CFPB shares enforcement over nonbanks with the FTC. *See* Dodd-Frank Act, *supra* note 1, § 1024(c)(3), 124 Stat. at 1989 (to be codified at 12 U.S.C. § 5514(c)(3)); *see also infra* note 81 and accompanying text.

43. Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (codified as amended at 15 U.S.C.A. §§ 1601–1667f (West 2009 & Supp. 2010)) [hereinafter TILA].

44. 12 U.S.C. §§ 2901–2908 (2006). Arguably, the CRA does not protect individual consumers but rather improves the access of entire segments of society to financial services.

45. Dodd-Frank Act, *supra* note 1, § 1021(a), 124 Stat. at 1979–80 (to be codified at 12 U.S.C. § 5511(a)). The CFPB is authorized to exercise its authority under ECLs for the purposes of ensuring that, with respect to consumer financial products and services:

> (1) consumers are provided with timely and understandable information to make responsible decisions about financial transactions; (2) consumers are protected from unfair, deceptive, or

rules and regulations, compliance supervision, and oversight of the entities under its jurisdiction (as described above), as well as education, market analysis, assessment of market risks, and enforcement.

Rulemaking Authority

The CFPB is authorized to prescribe rules and issue guidance necessary to implement and further the purposes and objectives of the ECLs.[46] The CFPA provides the CFPB with broad and powerful authority, in that it is given exclusive rulemaking authority to implement these federal laws, and its interpretations are to be given deference by the courts as the ECLs' exclusive interpreter.[47]

The CFPB's rulemaking authority is not unfettered, however, and must be exercised in accordance with certain standards, and in collaboration with certain other agencies. In prescribing regulations, the CFPB must consider "the potential benefits and costs to[, and other impact on,] consumers and covered persons,[48] including the potential reduction of access by consumers to consumer financial products or services resulting from" the regulation.[49] In addition, the CFPB must consult with the appropriate prudential regulators[50] or other federal agencies prior to proposing a rule and during the comment process regarding consistency with prudential, market, and systemic objectives of such agencies.[51] If any of these other agencies provides the CFPB with a written objection to the proposed rule, the CFPB must include in the adopting release a description of the objection and the basis for the CFPB decision, if any, regarding such objection.[52]

A member of the Financial Stability Oversight Council ("Council")[53] may petition the Council, and the Council may set aside all or a part of a regulation issued

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> abusive acts and practices and from discrimination; (3) outdated, unnecessary, or unduly burdensome regulations are regularly identified and addressed in order to reduce unwarranted regulatory burdens; (4) federal consumer financial law is enforced consistently, without regard to the status of a person as a depository institution, in order to promote fair competition; and (5) markets for consumer financial products and services operate transparently and efficiently to facilitate access and innovation.

Id. § 1021(b), 124 Stat. at 1980 (to be codified at 12 U.S.C. § 5511(b)).

46. See *supra* note 39 for a list of these ECLs.

47. Dodd-Frank Act, *supra* note 1, § 1022(b)(4), 124 Stat. at 1981 (to be codified at 12 U.S.C. § 5512(b)(4)).

48. "Covered person" is defined as "(A) any person that engages in offering or providing a consumer financial product or service; and (B) any affiliate of a person described in subparagraph (A) if such affiliate acts as a service provider to such person." *Id.* § 1002(6), 124 Stat. at 1956 (to be codified at 12 U.S.C. § 5481(6)).

49. *Id.* § 1022(b)(2)(A), 124 Stat. at 1980–81 (to be codified at 12 U.S.C. § 5512(b)(2)(A)).

50. Prudential regulators include the Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, Federal Reserve Board ("FRB"), and National Credit Union Administration. *Id.* § 1002(24), 124 Stat. at 1962 (to be codified at 12 U.S.C. § 5481(24)); *see also infra* note 67 and accompanying text.

51. Dodd-Frank Act, *supra* note 1, § 1022(b)(2)(B), 124 Stat. at 1981 (to be codified at 12 U.S.C. § 5512(b)(2)(B)).

52. *Id.* § 1022(b)(2)(C), 124 Stat. at 1981 (to be codified at 12 U.S.C. § 5512(b)(2)(C)).

53. The Financial Stability Oversight Council is created by Title III of the Dodd-Frank Act, *supra* note 1, 124 Stat. at 1520–70.

by the CFPB if the Council decides that the provision or regulation would jeopardize the safety and soundness of the U.S. banking system or the stability of the financial system.[54]

In promulgating rules and regulations, the CFPB is also authorized to "conditionally or unconditionally exempt any class of covered persons, service providers, or consumer financial products or services, from any provision of this title, or from any rule issued under this title, as the CFPB determines necessary or appropriate to carry out the purposes and objectives of this title."[55]

In connection with its rulemaking authority, the CFPB is charged with monitoring the risks associated with the offering and provision of consumer products and services in the financial market.[56] It is required to evaluate the risks and costs to consumers, the consumers' understanding of the product risks, available legal protections, the prevalence and growth rate of various consumer products, and any disproportionate effects on underserved communities.[57] The CFPB's monitoring and data collection are limited by rules regarding business confidentiality and consumer privacy.[58]

The CFPB may prescribe rules setting forth disclosure requirements to ensure that the features of any consumer financial product or service are "fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service."[59] In connection with this disclosure rulemaking authority, the CFPB may issue sample disclosure forms that have been validated through consumer testing.[60] The use of such model forms creates a safe harbor for the entity using such disclosures.[61]

Supervision

Scope

The CFPB has been granted supervisory authority over both nondepository entities and large depository institutions with assets exceeding $10 million.[62] Nondepository entities include covered persons that originate, broker, or service real estate-secured consumer loans, as well as larger market participants and those

54. *Id.* § 1023, 124 Stat. at 1985–86 (to be codified at 12 U.S.C. § 5513).

55. *Id.* § 1022(b)(3), 124 Stat. at 1981 (to be codified at 12 U.S.C. § 5512(b)(3)). The CFPB's decision to exempt entities or products must take into account:

> (i) the total assets of the class of covered persons; (ii) the volume of transactions involving consumer financial products or services in which the class of covered persons engages; and (iii) existing provisions of law which are applicable to the consumer financial product or service and the extent to which such provisions provide consumers with adequate protections.

Id.

56. *Id.* § 1022(c), 124 Stat. at 1981–83 (to be codified at 12 U.S.C. § 5512(c)).

57. *Id.*

58. *Id.*

59. *Id.* § 1032(a), 124 Stat. at 2006–07 (to be codified at 12 U.S.C. § 5532(a)).

60. *Id.* § 1032(b), 124 Stat. at 2007 (to be codified at 12 U.S.C. § 5532(b)).

61. *Id.* § 1032(d), 124 Stat. at 2007 (to be codified at 12 U.S.C. § 5532(d)).

62. *Id.* §§ 1024, 1025, 124 Stat. at 1987–93, 1990 (to be codified at 12 U.S.C. §§ 5514, 5515).

persons who, in offering or providing consumer financial products or services, are engaging in, or have engaged in, conduct that poses risks to consumers.[63] It also is to supervise any persons offering private education loans or payday loans to consumers.[64]

Nondepository Entities

In supervising nondepository institutions, the CFPB must require reports from, and conduct examinations of, its supervisees for the purposes of: "(A) assessing compliance with the requirements of Federal consumer financial laws; (B) obtaining information about the activities and compliance systems or procedures [of such entities]; and (C) detecting and assessing any risks to consumers and to markets for consumer financial products and services."[65] The CFPA also directs the CFPB to develop a risk-based supervisory program, determined by:

> (A) asset size of the [entity]; (B) the volume of the transactions involving consumer financial products or services in which the [entity] engages; (C) the risks to consumers created by the provision of such consumer financial products or services; (D) the extent to which institutions are subject to oversight by State authorities for consumer protection; and (E) any other factors that the [CFPB] determines to be relevant to a class of covered persons.[66]

In an effort to reduce the regulatory burden, duplication of effort, and undue burden on the supervisees, the CFPB is required to coordinate its supervisory activities with the supervisory activities conducted by prudential banking regulators and the state bank regulatory authorities; this coordination must include establishing schedules for examination and requirements regarding reports to be submitted by its supervisees.[67] In addition, the CFPB is, to the fullest extent possible, required to use reports submitted to either state or federal agencies, as well as publicly reported information.[68] Nonetheless, the CFPB's authority to require the reporting of information is not limited to reports made to other regulators. The CFPB may also prescribe rules regarding record retention and requirements for nondepository entities and their principals, officers, and directors to ensure that the entities are legitimate and are able to perform their obligations to consumers.[69] The CFPB must consult with state agencies in an effort to coordinate registration, bonding, and other requirements that the state may have previously established.[70]

63. *Id.* § 1024(a)(1), 124 Stat. at 1987 (to be codified at 12 U.S.C. § 5514(a)(1)).
64. *Id.*
65. *Id.* § 1024(b)(1), 124 Stat. at 1987 (to be codified at 12 U.S.C. § 5514(b)(1)).
66. *Id.* § 1024(b)(2), 124 Stat. at 1987–88 (to be codified at 12 U.S.C. § 5514(b)(2)).
67. *Id.* § 1024(b)(3), 124 Stat. at 1988 (to be codified at 12 U.S.C. § 5514(b)(3)); *see also supra* note 50.
68. Dodd-Frank Act, *supra* note 1, § 1024(b)(4), 124 Stat. at 1988 (to be codified at 12 U.S.C. § 5514(b)(4)).
69. *Id.* § 1024(b)(7), 124 Stat. at 1988–89 (to be codified at 12 U.S.C. § 5514(b)(7)).
70. *Id.* § 1024(b)(7)(D), 124 Stat. at 1989 (to be codified at 12 U.S.C. § 5514(b)(7)(D)).

Large Depository Institutions

While the CFPB has been given supervisory powers over depository institutions with total assets exceeding $10 million, these powers are more limited than those in regard to nondepository institutions, in that greater coordination with the institution's prudential regulator or state bank regulator is required.[71] The CFPB is also given exclusive supervisory authority over these large financial institutions in regard to compliance with the requirements of the ECLs and assessing market and consumer risks.[72] Similarly, the CFPB also must consult with the institution's regulators, in this instance the institution's prudential regulator, or the state bank regulator in an effort to coordinate examination and reporting requirements.[73]

In connection with these large depository institutions, the CFPB must coordinate and conduct simultaneous examinations of each of these institutions and share its draft report with the institution's other supervisory agency.[74] Prior to issuing a final examination report, the CFPB is also required to take into consideration the concerns and comments of the other agency.[75] If the supervisory determinations of the CFPB and the other supervisory agency are in conflict, the depository institution may request that the agencies coordinate and present "a joint statement of coordinated action," in which case the two agencies must provide such a statement within thirty days of the request.[76]

Smaller Depository Institutions

While the CFPB does not have supervisory or enforcement power over depository institutions with assets of less than $10 million, it may require reports from such institutions in connection with its duty to implement the ECLs and to assess and detect risks to consumers and consumer financial markets.[77] In addition, the CFPB may include an examiner on a sampling basis in examinations conducted by the smaller institution's prudential regulator to assess compliance with the ECLs.[78] The prudential regulator must cooperate with the CFPB and share examination information and reports.[79]

71. *Id.* § 1025(b)(2), 124 Stat. at 1990 (to be codified at 12 U.S.C. § 5515(b)(2)).
72. *Id.* § 1025(b)(1), 124 Stat. at 1990 (to be codified at 12 U.S.C. § 5515(b)(1)).
73. *Id.* § 1025(e)(1), 124 Stat. at 1991–92 (to be codified at 12 U.S.C. § 5515(e)(1)).
74. *Id.*
75. *Id.*
76. *Id.* § 1025(e)(3), 124 Stat. at 1992 (to be codified at 12 U.S.C. § 5515(e)(3)). If the agencies cannot agree or if one agency takes action without the other, the depository institution may institute an appeal to a governing panel, composed of a representative from the CFPB and the other agency, both of whom cannot have been involved in the supervisory determinations in conflict, as well as a representative from one of the other banking regulators, selected on a rotating basis. *Id.* § 1025(e)(4), 124 Stat. at 1992 (to be codified at 12 U.S.C. § 5515(e)(4)).
77. *Id.* § 1026(b), 124 Stat. at 1993–94 (to be codified at 12 U.S.C. § 5516(b)).
78. *Id.* § 1026(c), 124 Stat. at 1994 (to be codified at 12 U.S.C. § 5516(c)).
79. *Id.* § 1026(d), 124 Stat. at 1994 (to be codified at 12 U.S.C. § 5516(d)).

Enforcement

As is more fully discussed elsewhere,[80] the CFPB has also been granted enforcement authority in connection with the ECLs. To the extent that federal law authorizes the CFPB and another federal agency to have enforcement authority in connection with an ECL, the CFPB is granted exclusive enforcement authority over that law in connection with nondepository entities and large depository institutions.[81] The prudential regulators of smaller depository institutions have exclusive enforcement authority over those institutions in connection with compliance with the ECLs.[82]

Miscellaneous CFPB Authority

The CFPB has been granted authority in a number of additional areas. It has power to study and possibly ban the inclusion of arbitration clauses in connection with consumer financial products.[83] The CFPB may also prescribe rules prohibiting "unfair, deceptive, or abusive acts or practices in connection with any transaction with a consumer for a consumer financial product or service."[84]

The CFPB must also establish, in consultation with other federal regulators, reasonable procedures that will provide a timely response to consumer complaints against, or inquiries concerning, covered persons.[85] In turn, covered persons subject to supervision and enforcement by the CFPB must provide a timely response to a CFPB inquiry into an alleged complaint and must comply with a consumer request for information within the covered person's control.[86]

Title XIV—Mortgage Reform and Anti-Predatory Lending Act

Introduction

Title XIV of the Dodd-Frank Act enacts the Mortgage Reform and Anti-Predatory Lending Act ("Mortgage Reform Act").[87] The Mortgage Reform Act is intended

80. *See supra* notes 39–44 and accompanying text; *see also* John L. Ropiequet, Christopher S. Najeva & L. Jean Noonan, *Fair Lending Developments: Enforcement Comes to the Fore*, 66 Bus. Law. 447 (2011) (in this *Annual Survey*).

81. Dodd-Frank Act, *supra* note 1, §§ 1024(c), 1025(c), 124 Stat. at 1989, 1991 (to be codified at 12 U.S.C. §§ 5514(c), 5515(c)). The FTC retains some enforcement authority over nonbanks, and the CFPB must coordinate an enforcement regulation agreement with the FTC. *Id.* § 1024(c)(3), 124 Stat. at 1989 (to be codified at 12 U.S.C. § 5515(c)(3)); *see also supra* note 42.

82. Dodd-Frank Act, *supra* note 1, § 1026(c), 124 Stat. at 1994 (to be codified at 12 U.S.C. § 5516(c)).

83. *Id.* § 1028(a), 124 Stat. at 2003–04 (to be codified at 12 U.S.C. § 5518(a)); *see also* Alan S. Kaplinsky, Mark J. Levin & Martin C. Bryce, Jr., *Arbitration Developments: Has the Supreme Court Finally Stepped In?*, 66 Bus. Law. 529, 537–38 (2011) (in this *Annual Survey*).

84. Dodd-Frank Act, *supra* note 1, § 1031(b), 124 Stat. at 2005–06 (to be codified at 12 U.S.C. § 5531(b)).

85. *Id.* § 1034(a), 124 Stat. at 2008 (to be codified at 12 U.S.C. § 5534(a)).

86. *Id.* § 1034(b), (c), 124 Stat. at 2009 (to be codified at 12 U.S.C. § 5534(b), (c)). Responses to such requests are limited by business confidentiality and consumer privacy requirements. *Id.*

87. *Id.* §§ 1400–1498, 124 Stat. at 2136–2212; *see also* Robert A. Cook & Meghan Musselman, *Summary of the Mortgage Lending Provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 64 Consumer Fin. L.Q. Rep. 231 (2010).

to address perceived abuses related to subprime mortgages and amends TILA in an effort to ensure that consumers "receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive, or abusive."[88] Most of the substantive provisions of the Mortgage Reform Act are designated as consumer protection laws under the jurisdiction of the CFPB.[89]

Residential Mortgage Loan Origination Standards

The Mortgage Reform Act imposes a number of new requirements and restrictions on "mortgage originators."[90]

Mortgage originators are required to be qualified and registered or licensed in accordance with applicable state or federal law, including the SAFE Act,[91] and must include on all loan documents their unique identifier assigned by the Nationwide Mortgage Licensing System and Registry.[92]

The Mortgage Reform Act also bans "steering" incentives, by prohibiting mortgage originators from receiving yield spread premiums or any other compensation that varies based on the terms of the loan other than the amount of the principal.[93] Mortgage originators cannot receive any compensation from any person other than the consumer except if the consumer has not paid any compensation directly to the mortgage originator and has not paid any upfront discount points, origination points, or fees other than bona fide third party charges.[94]

88. Dodd-Frank Act, *supra* note 1, § 1402, 124 Stat. at 2138 (to be codified at 15 U.S.C. § 1639b(a)(2)).

89. *Id.* § 1400, 124 Stat. at 2136 (to be codified at 15 U.S.C. § 1601 note).

90. *Id.* §§ 1401–1405, 124 Stat. at 2137–42 (to be codified at 15 U.S.C. §§ 1602, 1639b). A "mortgage originator" is any person who, for direct or indirect compensation or gain: "(i) takes a residential mortgage loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan." *Id.* § 1401, 124 Stat. at 2137 (to be codified at 15 U.S.C. § 1602(cc)(2)(A)). A person "assists a consumer in obtaining or applying to obtain a residential mortgage loan" by, among other things, "advising on residential mortgage loan terms (including rates, fees, and other costs), preparing residential mortgage loan packages, or collecting information on behalf of the consumer with regard to a residential mortgage loan." *Id.*, 124 Stat. at 2138 (to be codified at 15 U.S.C. § 1602(cc)(4)). Any person who holds himself out to the public as being able to provide mortgage origination services is also considered a mortgage originator. *Id.*, 124 Stat. at 2137 (to be codified at 15 U.S.C. § 1602(cc)(2)(B)). The term does not include persons who perform purely administrative or clerical tasks relating to a residential mortgage loan application. *Id.*, 124 Stat. at 2137 (to be codified at 15 U.S.C. § 1602(cc)(2)(C)). And, unlike the Secure and Fair Enforcement for Mortgage Licensing Act of 2008, the Mortgage Reform Act expressly excludes servicers and their employees, agents, and contractors from the definition of "mortgage originator." *Id.* § 1401, 124 Stat. at 2138 (to be codified at 15 U.S.C. § 1602(cc)(2)(G)).

91. On the SAFE Act, see Julie R. Caggiano, Therese G. Franzén & Jennifer L. Dozier, *Developments in State and Federal Mortgage Lending Laws: Predatory Lending and Beyond*, 65 Bus. Law. 583, 584–86 (2010) (in the 2010 *Annual Survey*); Julie R. Caggiano, Therese G. Franzén & Jennifer L. Dozier, *Mortgage and Predatory Lending Law Developments*, 64 Bus. Law. 517, 518–21 (2009) (in the 2009 *Annual Survey*).

92. Dodd-Frank Act, *supra* note 1, § 1402, 124 Stat. at 2139 (to be codified at 15 U.S.C. § 1639b(b)(1)).

93. *Id.* § 1403, 124 Stat. at 2139 (to be codified at 15 U.S.C. § 1639b(c)(1)).

94. *Id.*, 124 Stat. at 2139–40 (to be codified at 15 U.S.C. § 1639b(c)(2)).

The Mortgage Reform Act directs the FRB[95] to prescribe regulations that prohibit mortgage originators from engaging in certain mortgage origination practices that constitute improper steering,[96] and grants broad discretionary authority to the CFPB to issue regulations prohibiting any terms or practices that it finds to be abusive, unfair, deceptive, or predatory.[97]

Minimum Underwriting Standards for Mortgages

A creditor is prohibited from making a residential mortgage loan "unless [it] makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance . . . , and assessments."[98] This determination is to be made by examining the consumer's credit history, current and expected income, current obligations, debt-to-income ratio, employment status, and other financial resources.[99] The determination cannot be based on the consumer's equity in the property securing the loan.[100]

The creditor must verify the consumer's income and assets "by reviewing the consumer's Internal Revenue Service Form W-2, tax returns, payroll receipts, [bank] records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets."[101]

The creditor must use a fully amortizing repayment schedule for determining the consumer's ability to repay the loan.[102] The Mortgage Reform Act provides guidance for determining the ability to repay for nonstandard loans, such as negative amortization and interest-only loans, calculating the monthly payment amount for loans

95. Final regulations required by the Mortgage Reform Act are to be issued within eighteen months after the designated transfer date and must take effect no later than twelve months after issuance. *Id.* § 1400(c), 124 Stat. at 2136 (to be codified at 15 U.S.C. § 1602 note). The regulations will be issued by the CFPB when authority over the Mortgage Reform Act transfers to the CFPB on the designated transfer date. *Id.* §§ 1061(b), 1062, 124 Stat. at 2036, 2039–40 (to be codified at 12 U.S.C. §§ 5581(b), 5582). On September 20, 2010, United States Treasury Secretary Timothy Geithner announced that the designated transfer date is July 21, 2011. *See* Designated Transfer Date, 75 Fed. Reg. 57252, 57252 (Sept. 20, 2010).

96. Prohibited practices include (i) steering a consumer to a residential mortgage loan that the consumer lacks a reasonable ability to repay (in accordance with regulations under TILA) or that has predatory characteristics, such as equity-stripping, excessive fees, or abusive terms; (ii) steering a consumer from a "qualified mortgage" to a mortgage loan that is not a "qualified mortgage"; (iii) "abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age"; (iv) "mischaracterizing the credit history of a consumer or the mortgage loans available to a consumer"; (v) mischaracterizing the appraised value of the property securing the residential mortgage loan; or (vi) discouraging a consumer from seeking a residential mortgage loan from another mortgage originator if a creditor is unable to suggest, offer, or recommend a loan that is less expensive than a loan for which the consumer qualifies. Dodd-Frank Act, *supra* note 1, § 1403, 124 Stat. at 2140 (to be codified at 15 U.S.C. § 1639b(c)(3)).

97. *Id.* § 1405, 124 Stat. at 2141–42 (to be codified at 15 U.S.C. § 1639b(e)).

98. *Id.* § 1411, 124 Stat. at 2142 (to be codified at 15 U.S.C. § 1639c(a)(1)).

99. *Id.*, 124 Stat. at 2143 (to be codified at 15 U.S.C. § 1639c(a)(3)).

100. *Id.*

101. *Id.* (to be codified at 15 U.S.C. § 1639c(a)(4)).

102. *Id.* (to be codified at 15 U.S.C. § 1639c(a)(3)).

that do not have substantially equal monthly payments, and refinancing hybrid loans with the current lender.[103] There is a rebuttable presumption that if a loan is a "qualified mortgage,"[104] then the consumer has the ability to repay the loan.[105]

The Mortgage Reform Act eliminates prepayment penalties on residential mortgage loans that do not qualify as lower-priced, fixed-rate "qualified mortgages."[106] Lower priced, fixed-rate "qualified mortgages" may contain prepayment penalties provided the penalties are phased out from a maximum of 3 percent in the first year, 2 percent in the second year, 1 percent in the third year, and no prepayment penalty thereafter.[107] Further, a creditor may not offer a residential mortgage loan with a prepayment penalty unless it also offers a loan without a prepayment penalty.[108]

New Disclosures for Mortgage Loans

The Mortgage Reform Act imposes several new disclosure requirements in connection with residential mortgage loans. These disclosure requirements include the following:

- pre-consummation disclosure and counseling for negative amortization loans;[109]
- pre-consummation disclosure of state anti-deficiency protection;[110]
- disclosure of the creditor's partial payment acceptance policy;[111]
- disclosure of the initial and fully indexed monthly principal and interest payment amounts and total payment amounts for variable rate loans with escrow accounts;[112]

103. *Id.*, 124 Stat. at 2143–45 (to be codified at 15 U.S.C. § 1639c(a)(6)).

104. A "qualified mortgage" is any residential mortgage loan that meets all of the following requirements: (i) regular loan payments do not result in an increase in the principal balance or allow the consumer to defer repayment of principal; (ii) except as permitted by regulation, it does not have a balloon payment "that is more than twice as large as the average of earlier scheduled payments"; (iii) the consumer's income and financial resources are verified and documented; (iv) for a fixed rate loan, "the underwriting process is based on a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments"; (v) for an adjustable rate loan, "the underwriting is based on the maximum rate permitted under the loan during the first 5 years, and a payment schedule that fully amortizes the loan over the loan term and takes into account all applicable taxes, insurance, and assessments"; (vi) the loan complies with any guidelines or regulations established by the CFPB regarding ratios of total monthly debt-to-income or any alternative measure determined by the CFPB; (vii) the total points and fees do not exceed 3 percent of the total loan amount; (viii) the loan term does not exceed thirty years, with limited exceptions; and (ix) in the case of a reverse mortgage, one that meets the standards for a qualified mortgage, as set by the CFPB. *Id.* § 1412, 124 Stat. at 2145–46 (to be codified at 15 U.S.C. § 1639c(b)(2)(A)).

105. *Id.* § 1412, 124 Stat. at 2145 (to be codified at 15 U.S.C. § 1639c(b)(1)).

106. *Id.* § 1414(a), 124 Stat. at 2149 (to be codified at 15 U.S.C. § 1639c(c)(1)(A)).

107. *Id.*, 124 Stat. at 2150 (to be codified at 15 U.S.C. § 1639c(c)(3)).

108. *Id.* (to be codified at 15 U.S.C. § 1639c(c)(4)).

109. *Id.* § 1414(b), 124 Stat. at 2151–52 (to be codified at 15 U.S.C. § 1639c(f)).

110. *Id.* § 1414(c), 124 Stat. at 2152 (to be codified at 15 U.S.C. § 1639c(g)).

111. *Id.* § 1414(d), 124 Stat. at 2152–53 (to be codified at 15 U.S.C. § 1639c(h)).

112. *Id.* § 1419, 124 Stat. at 2154–55 (to be codified at 15 U.S.C. § 1638(a)(16)).

- disclosure of the aggregate amount of settlement charges, fees, and interest and the wholesale rate of the creditor's cost of funds for all residential mortgage loans;[113]
- six-month advance notice before a hybrid adjustable rate mortgage with an introductory fixed rate is reset;[114]
- monthly statement disclosures on a form to be developed by the CFPB;[115]
- pre-closing disclosure regarding escrow payments for certain first lien mortgages;[116] and
- disclosure for non-escrowed loans.[117]

Liability and Enforcement

Mortgage originators that fail to comply with the new qualification requirements, anti-steering prohibitions, and restrictions on compensation are subject to civil liability for the greater of the actual damages suffered by the consumer or three times the total amount of compensation to the mortgage originator in connection with the residential mortgage loan involved in the violation, plus costs, including reasonable attorney's fees.[118] A consumer may assert violations of the mortgage originator compensation restrictions or the ability to repay standard as a partial defense in a foreclosure action by the creditor or assignee without regard to the statute of limitations.[119] Enhanced damages under TILA equal to the sum of all finance charges and fees paid by the consumer are also available for violations of the restrictions on mortgage originator compensation and the ability to repay standard.[120] In addition, the Mortgage Reform Act raises the limits on TILA class action damages to the lesser of $1,000,000 or 1 percent of the creditor's or mortgage originator's net worth and extends the limitations period for civil actions under TILA to three years.[121] State attorneys general are given expanded authority to enforce the requirements under the Mortgage Reform Act.[122]

HOEPA Revisions

The Mortgage Reform Act also amended the federal high-cost loan provisions of the Home Ownership and Equity Protection Act ("HOEPA").[123] First, the Mortgage

113. *Id.*, 124 Stat. at 2155 (to be codified at 15 U.S.C. § 1638(a)(17)).
114. *Id.* § 1418, 124 Stat. at 2153–54 (to be codified at 15 U.S.C. § 1638a).
115. *Id.* § 1420, 124 Stat. at 2155–56 (to be codified at 15 U.S.C. § 1638(f)).
116. *Id.* § 1461, 124 Stat. at 2178–81 (to be codified at 15 U.S.C. § 1639d(a)–(i)).
117. *Id.* § 1462, 124 Stat. at 2181–82 (to be codified at 15 U.S.C. § 1639d(j)).
118. *Id.* § 1404, 124 Stat. at 2141 (to be codified at 15 U.S.C. § 1639b(d)).
119. *Id.* § 1413, 124 Stat. at 2148–49 (to be codified at 15 U.S.C. § 1640(k)).
120. *Id.* § 1416, 124 Stat. at 2153 (to be codified at 15 U.S.C. § 1640(a)).
121. *Id.* § 1422, 124 Stat. at 2157 (to be codified at 15 U.S.C. § 1640(e)).
122. *Id.*
123. Pub. L. No. 103-325, 108 Stat. 2191 (1994) (codified in scattered sections of 5, 12, 15, 18, 31 & 42 U.S.C.).

Reform Act expanded the scope of HOEPA to include purchase-money loans and open-end credit plans.[124] Second, the Mortgage Reform Act lowered the annual percentage rate ("APR") threshold and ties it to the average prime offer rate ("APOR") rather than the yield on U.S. Treasury Securities.[125] The APR thresholds are lowered to 6.5 percent above the APOR for a first lien transaction and 8.5 percent above the APOR for a subordinate lien transaction.[126] A separate APR threshold of 8.5 percent above the APOR is applicable if the dwelling securing a first lien loan is personal property (e.g., a manufactured home) and the transaction is for an amount less than $50,000.[127] Third, the Mortgage Reform Act lowers the points and fees threshold from 8 percent of the total loan amount to: (i) 5 percent of the total transaction amount for transactions of $20,000 or more; and (ii) the lesser of 8 percent of the total transaction amount or $1,000 for transactions of less than $20,000.[128]

In addition to lowering the points and fees threshold, the Mortgage Reform Act also modified the definition of points and fees.[129] As amended, points and fees includes (i) all compensation paid to a mortgage originator by a consumer or creditor (directly or indirectly); (ii) premiums and charges payable at closing for credit insurance (e.g., accident, loss-of-income, life, or health insurance); (iii) the maximum prepayment penalties that may be charged under the terms of the loan; (iv) all prepayment penalties incurred by the consumer for a refinance of a loan made or currently held by the same creditor or an affiliate; and (v) for open-end loans, the minimum additional fees required to draw down the total credit line.[130] Up to two bona fide discount points may be excluded from the points and fees threshold (subject to certain conditions) as well as government agency insurance premiums.[131] Private mortgage insurance premiums up to a certain amount may also be excluded, provided that requirements regarding refunds are met.[132]

The Mortgage Reform Act also added a third high-cost loan threshold relative to prepayment penalties.[133] Specifically, a loan is automatically a high-cost loan (irrespective of the APR and points and fees thresholds) if the loan documents permit a prepayment penalty to be charged more than thirty-six months after closing or if the prepayment penalty exceeds 2 percent of the amount prepaid.[134] The substantive restrictions applicable to high-cost loans were also amended and expanded.[135]

Significantly, the Mortgage Reform Act also added a cure provision for high-cost mortgage loans.[136]

124. Dodd-Frank Act, *supra* note 1, § 1431, 124 Stat. at 2157–60 (to be codified at 15 U.S.C. § 1602(aa)).
125. *Id.*
126. *Id.*, 124 Stat. at 2157 (to be codified at 15 U.S.C. § 1602(aa)(1)(A)(i)).
127. *Id.*
128. *Id.*, 124 Stat. at 2157–58 (to be codified at 15 U.S.C. § 1602(aa)(1)(A)(ii)).
129. *Id.*, 124 Stat. at 2159 (to be codified at 15 U.S.C. § 1602(aa)(4)).
130. *Id.*
131. *Id.*, 124 Stat. at 2159–60 (to be codified at 15 U.S.C. § 1602(dd)).
132. *Id.*, 124 Stat. at 2159 (to be codified at 15 U.S.C. § 1602(aa)(4)(D)).
133. *Id.*, 124 Stat. at 2158 (to be codified at 15 U.S.C. § 1602(aa)(1)(A)(iii)).
134. *Id.*
135. *Id.*, §§ 1432, 1433, 124 Stat. at 2160–63 (to be codified at 15 U.S.C. § 1639).
136. *Id.* § 1433(f), 124 Stat. at 2163 (to be codified at 15 U.S.C. § 1639(v)).

Mortgage Servicing Practices

The Mortgage Reform Act also created new requirements regarding mortgage servicing practices by amending TILA. The Mortgage Reform Act requires establishment of a mandatory escrow account for first lien loans secured by the consumer's principal dwelling in certain instances.[137] Mandatory escrow accounts generally must remain in existence for at least five years from consummation.[138] New disclosures are required both in connection with mandatory escrow accounts[139] and if accounts are not mandatory or the consumer elects to close an existing account.[140]

The Mortgage Reform Act also amended section 6 of the Real Estate Settlement Procedures Act ("RESPA") relative to servicing practices.[141] Under the Mortgage Reform Act, a servicer is prohibited from: (i) force-placing hazard insurance (except under certain circumstances); (ii) charging fees for responding to valid qualified written requests; (iii) failing to respond timely to a borrower's request to correct certain errors; (iv) failing to respond to a borrower's request for information regarding the owner/assignee of the loan within ten business days; and (v) failing to comply with any other obligation as established by rule.[142] The response times relative to qualified written requests are reduced to five days (in which to acknowledge receipt of a request) and thirty days (in which to take action upon the request).[143]

Conclusion

As the most sweeping financial reform legislation since the 1930s, the Dodd-Frank Act is guaranteed to change significantly the financial landscape of the United States. With the creation of the CFPB, many industries will find themselves subject to significant federal regulation for the first time. Others will find their regulatory and legal environments (including their potential liabilities) significantly changed and perhaps heavily increased. What remains unclear is precisely how most of the provisions will be implemented and whether the reforms will serve to stabilize the industry and benefit consumers. As rulemaking gets underway, those directly impacted by the reforms can only wait for a clearer picture of the legal and regulatory environment going forward.

137. *Id.* § 1461, 124 Stat. at 2178–81 (to be codified at 15 U.S.C. § 1639d).
138. *Id.*, 124 Stat. at 2179 (to be codified at 15 U.S.C. § 1639d(d)).
139. *Id.*, 124 Stat. at 2180–81 (to be codified at 15 U.S.C. § 1639d(h)).
140. *Id.* § 1462, 124 Stat. at 2181–82 (to be codified at 15 U.S.C. § 1639d(j)).
141. *Id.* § 1463, 124 Stat. at 2182–84 (to be codified at 12 U.S.C. § 2605); *see also* John P. Kromer, Sanford Shatz & Jonathan W. Cannon, *2010 Survey of RESPA Developments*, 66 Bus. Law. 435, 438–39 (2011) (in this *Annual Survey*).
142. Dodd-Frank Act, *supra* note 1, § 1463, 124 Stat. at 2182 (to be codified at 12 U.S.C. § 2605(k)(1)).
143. *Id.*, 124 Stat. at 2184 (to be codified at 12 U.S.C. § 2605(m)).

Fair Credit Reporting Act Update—2010

*By Andrew M. Smith and Peter Gilbert**

Introduction

This year, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Consumer Financial Protection Act ("CFPA")[1] revised the Fair Credit Reporting Act ("FCRA")[2] enforcement and rulemaking scheme, and imposed new obligations on businesses that use consumer reports. Meanwhile, as discussed below, agency rulemaking efforts under the Fair and Accurate Credit Transactions Act ("FACT Act")[3] continued, with amendments to the Free Credit Report Rule and the completion of the final major rule under the FACT Act, the Risk-Based Pricing Rule.

Legislative Developments: The CFPA

Credit Scoring Provisions

The CFPA amended the FCRA in a variety of ways. Most immediately, it amends the adverse action and risk-based pricing provisions in FCRA section 615 to require persons that use credit scores in connection with consumer transactions to include those scores in any adverse action or risk-based pricing notice provided to the consumer.[4] In addition, the person must disclose the following: the range of scores under the credit scoring model used; the date that the score was created and the person that provided the credit score or the credit file upon which the score is based; and the key factors that "adversely affected" the score.[5]

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* Andrew M. Smith is a partner in the Washington, D.C. office of Morrison & Foerster LLP. Peter Gilbert is Assistant General Counsel at Capital One Financial Corporation in Richmond, Virginia.

1. Pub. L. No. 111-203, tit. X, 124 Stat. 1376, 1955 (2010) [hereinafter CFPA].
2. Pub. L. No. 91-508, tit. VI, 84 Stat. 1114, 1128 (1970) (codified as amended at 15 U.S.C.A. §§ 1681–1681x (West 2009 & Supp. 2010)) [hereinafter FCRA].
3. Pub. L. No. 108-159, 117 Stat. 1952 (2003) (codified in scattered sections of 15 & 20 U.S.C.) [hereinafter FACT Act]; *see generally* Andrew M. Smith, Peter Gilbert & Scott Johnson, *Fair Credit Reporting Act Update—2009*, 65 Bus. Law. 595, 595–601 (2010) (in the 2010 *Annual Survey*).
4. CFPA, *supra* note 1, § 1100F, 124 Stat. at 2112 (amending 15 U.S.C. § 1681m); *see also infra* notes 59–100 and accompanying text (discussing risk-based pricing notices and the Risk-Based Pricing Rule).
5. CFPA, *supra* note 1, § 1100F, 124 Stat. at 2112 (amending 15 U.S.C. § 1681m(a)(2)(B)).

The term "credit score" means a value derived from a modeling system used by a person that makes or arranges a loan, and does not include a rating of an automated underwriting system that considers factors in addition to consumer report information such as loan-to-value ratio, the amount of down payment, or the financial assets of a consumer.[6] Thus, for example, a consumer report user would not be required to disclose a score developed for use by insurers, and would not be required to disclose a proprietary score that includes factors, such as loan-to-value ratio, that are not derived from a consumer report.

This provision of the CFPA will be effective on the date ("Transfer Date") designated by the Secretary of the Treasury for the transfer of functions under existing consumer credit laws to the new Consumer Financial Protection Bureau ("CFPB").[7]

The CFPA also requires the CFPB to study and report on the "nature, range, and size of variations between the credit scores sold to creditors and those sold to consumers" by the nationwide consumer reporting agencies.[8] The nationwide consumer reporting agencies are required to disclose to a consumer a credit score, upon the consumer's request, but are permitted to disclose an "educational" score, rather than a score actually used by lenders to make decisions about consumers.[9] This study is motivated by the apparent belief of some members of Congress that educational credit scores may be less valuable for consumers.[10]

Addition of Securities Regulators

The CFPA also corrects what may be a longstanding oversight by Congress: the omission of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") from the FCRA. The CFPA adds enforcement authority for these two agencies with respect to persons subject to their respective jurisdictions.[11]

The CFPA also amends three provisions to add rulemaking authority for the SEC and CFTC. Specifically, the FCRA is amended to require the SEC and CFTC

6. *Id.* (amending 15 U.S.C. § 1681m(h)(5)(E)).

7. CFPA, *supra* note 1, § 1100H, 124 Stat. at 2113 (setting the effective date for § 1100F); *see also id.* § 1062, 124 Stat. at 2039–40 (to be codified at 12 U.S.C. § 5582) (explaining the designated transfer date); *id.* § 1061, 124 Stat. at 2035–39 (to be codified at 12 U.S.C. § 5581) (explaining the transfer of functions to the new Consumer Financial Protection Bureau). On September 20, 2010, United States Treasury Secretary Timothy Geithner announced that the designated transfer date is July 21, 2011. *See* Designated Transfer Date, 75 Fed. Reg. 57252, 57252 (Sept. 20, 2010).

8. CFPA, *supra* note 1, § 1078, 124 Stat. at 2076. The nationwide consumer reporting agencies are Equifax Inc., Experian Information Solutions, Inc., and TransUnion LLC. *See, e.g.*, Free Annual File Disclosures, 75 Fed. Reg. 9726, 9726 n.2 (Mar. 3, 2010) (to be codified at 16 C.F.R. pt. 610).

9. 15 U.S.C. § 1681g(f)(7)(A) (2006) (permitting a consumer reporting agency to disclose "a credit score that assists the consumer in understanding the credit scoring assessment of the credit behavior of the consumer").

10. *What Borrowers Need to Know About Credit Scoring Models and Credit Scores: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 110th Cong. 24 (2008) (comments of Rep. Jackie Speier (D-Cal.) regarding "FAKO" scores).

11. CFPA, *supra* note 1, § 1088(a)(10)(B), 124 Stat. at 2089–90 (to be codified at 15 U.S.C. § 1681s(b)).

to make an "Identity Theft Red Flags Rule" for persons under the respective jurisdiction of the two agencies,[12] and to require the CFTC to issue rules regarding the secure disposal of consumer report information.[13] The FACT Act is amended to require the CFTC to make an "Affiliate Marketing Rule" for persons under its jurisdiction.[14] The CFPA does not specify a time period within which the SEC and CFTC are required to issue these rules.

Amendments to Administrative Enforcement Provisions

The CFPA overhauls the administrative enforcement scheme under the FCRA. As noted, the CFPA adds enforcement authority for the SEC and the CFTC.[15] The Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, Office of Thrift Supervision, and National Credit Union Administration (together, the "Banking Agencies") generally will retain their authority to enforce the FCRA against depository institutions, but the CFPB will have primary enforcement authority against banks and credit unions with assets in excess of ten billion dollars.[16] The Banking Agencies have enforcement authority over depository institutions with assets of ten billion dollars or less, but the CFPB can make enforcement recommendations.[17]

The CFPA also provides the CFPB with general enforcement power "with respect to any person subject to this title"—that is, any person subject to the FCRA, and the jurisdiction over which is not committed to another agency.[18] The FTC, however, continues to maintain its general enforcement jurisdiction under the FCRA, "subject to subtitle B of the [CFPA]."[19] Subtitle B of the CFPA sets forth the enforcement jurisdiction of the CFPB generally,[20] and provides that the CFPB shall have exclusive enforcement jurisdiction over non-depository "covered persons," which are defined to include certain participants in consumer credit markets, such as non-bank lenders, mortgage brokers, payday lenders, debt collectors, consumer reporting agencies, and the like.[21] The CFPB, however, is required to negotiate with the FTC "an agreement for coordinating with respect to enforcement actions by each agency regarding the offering or provision of consumer financial products or services by any covered person."[22] In addition, consumer reports that

12. *Id.* § 1088(a)(8), 124 Stat. at 2087–88 (amending 15 U.S.C. § 1681m(e)(1)).
13. *Id.* § 1088(a)(12), 124 Stat. at 2091–92 (amending 15 U.S.C. § 1681w(a)(1)).
14. *Id.* § 1088(b)(3), 124 Stat. at 2092 (to be codified at 15 U.S.C. § 1681s-3 note) (amending FACT Act § 214(b)).
15. *See supra* note 11 and accompanying text.
16. CFPA, *supra* note 1, § 1025(c), 124 Stat. at 1991 (to be codified at 12 U.S.C. § 5515(c)).
17. *Id.* § 1026(d), 124 Stat. at 1994 (to be codified at 12 U.S.C. § 5516(d)).
18. *Id.* § 1088(a)(10)(B), 124 Stat. at 2089–90 (amending 15 U.S.C. § 1681s(b)).
19. *Id.* § 1088(a)(10)(A), 124 Stat. at 2088 (amending 15 U.S.C. § 1681s(a)).
20. *Id.* §§ 1021–1029A, 124 Stat. at 1979–2004 (to be codified at 12 U.S.C. §§ 5511–5519).
21. *Id.* § 1024(c), 124 Stat. at 1989 (to be codified at 12 U.S.C. § 5514(c)) (authority over non-depository covered persons); *id.* § 1002(5), 1002(6) & 1002(15), 124 Stat. at 1956, 1957–60 (to be codified at 12 U.S.C. § 5481(5), (6) & (15)) (defining "consumer financial product or service," "covered person," and "financial product or service").
22. *Id.* § 1024(c)(3), 124 Stat. at 1989 (to be codified at 12 U.S.C. § 5514(c)(3)).

are not used in connection with offering "consumer financial products or services" are excluded from the CFPB's jurisdiction, meaning that the CFPB appears to have no authority over consumer reporting agencies that do not provide consumer reports in connection with consumer credit or deposit transactions, for example consumer reporting agencies that provide employment background reports, insurance underwriting reports, tenant screening reports, and reports used in connection with government licensing or benefits decisions.[23] Thus, as a practical matter, the CFPB and the FTC appear to share residual enforcement jurisdiction under the FCRA. Until the memorandum of understanding is negotiated between the two agencies, and perhaps even for some time afterward, it appears as though non-depository entities, the jurisdiction of which is not specifically committed to a specific federal regulator, will be subject to an uncertain enforcement scheme involving both the FTC and the CFPB.

In addition to rearranging the enforcement authority of federal agencies under the FCRA, the CFPA also restated the FTC's authority to obtain civil penalties in the amount of $2,500 "in the event of a knowing violation, which constitutes a pattern or practice of violations of this title."[24] The FTC had recently increased this amount to $3,500 per violation, pursuant to the Federal Civil Penalties Inflation Adjustment Act of 1990.[25] The effect of the CFPA amendment will be to reduce this amount back to $2,500.

Amendments to Rulemaking Authority

Existing rulemaking power, which is currently diffused among the Banking Agencies and FTC, will for the most part transfer to the CFPB on the Transfer Date. The CFPB will have general rulemaking authority under the FCRA, and its rules will apply to all persons subject to the FCRA, "notwithstanding the enforcement authorities granted to other agencies under" the FCRA.[26] This general authority is now held jointly by the Banking Agencies.

In addition, the CFPB will be solely responsible for prescribing many of the specific rules required by the FACT Act, including rules regarding the following: the provision of free credit reports to consumers;[27] the use of medical information by lenders and the sharing of medical information among affiliated companies;[28] the receipt of address discrepancy notices by users of consumer reports;[29] prescreen opt-out notifications;[30] the provision of risk-based pricing notices to

23. *Id.* § 1002(15)(A)(ix)(I)(cc), 124 Stat. at 1959 (to be codified at 12 U.S.C. § 5481(15)(A)(ix)(I)(cc)).

24. *Id.* § 1088(a)(10)(A), 124 Stat. at 2088 (amending 15 U.S.C. § 1681s(a)).

25. *See* 28 U.S.C. § 2461 note (2006); *see also* Federal Civil Penalties Inflation Adjustment Act, 74 Fed. Reg. 857, 858 (Jan. 9, 2009) (to be codified at 16 C.F.R. § 1.98(m)).

26. CFPA, *supra* note 1, § 1088(a)(10)(E), 124 Stat. at 2090 (amending 15 U.S.C. § 1681s(e)).

27. *Id.* § 1088(b)(2), 124 Stat. at 2092 (to be codified at 15 U.S.C. § 1681j note) (amending FACT Act § 211(d)).

28. *Id.* § 1088(a)(4), 124 Stat. at 2087 (amending 15 U.S.C. § 1681b(g)).

29. *Id.* § 1088(a)(5), 124 Stat. at 2087 (amending 15 U.S.C. § 1681c(h)(2)(A)).

30. *Id.* § 1088(a)(7), 124 Stat. at 2087 (amending 15 U.S.C. § 1681m(d)(2)(B)).

consumers;[31] the establishment of procedures regarding the furnishing of accurate information to consumer reporting agencies;[32] the receipt of disputes directly from consumers;[33] the provision of negative information to consumer reporting agencies;[34] and certain definitions relating to the rights of identity theft victims.[35] Rules regarding the receipt and use of information for marketing purposes by affiliated companies will be made by the CFPB in conjunction with the SEC and CFTC.[36] Importantly, however, the authority to make regulations to prevent and mitigate identity theft (the so-called "Identity Theft Red Flags Rule") and to require the proper disposal of consumer report information will remain with the FTC, SEC, CFTC, and the Banking Agencies.[37]

Free Annual File Disclosure Rule

The FTC initially promulgated the Free Annual File Disclosure Rule to establish procedures for consumers to obtain free annual file disclosures from consumer reporting agencies.[38] Section 205 of the Credit Card Accountability Responsibility and Disclosure Act ("CARD Act")[39] required the FTC to issue a rule to prevent deceptive marketing of free credit reports.[40] To fulfill that requirement, the FTC amended the Free Annual File Disclosure Rule.[41] These amendments became effective April 2, 2010, except with respect to disclosures specific to television and radio advertisement, which became effective September 1, 2010.[42] The amendments require disclosures in connection with offering free credit reports and limit the extent to which "nationwide consumer reporting agencies" may market products and services to consumers seeking their free annual disclosures.[43]

Communications Through Centralized Source

The original Free Annual File Disclosure Rule required nationwide consumer reporting agencies ("CRAs") to establish a "Centralized Source" from which con-

31. *Id.* § 1088(a)(9), 124 Stat. at 2088 (amending 15 U.S.C. § 1681m(h)(6)).
32. *Id.* § 1088(a)(11)(C), 124 Stat. at 2091 (amending 15 U.S.C. § 1681s-2(e)).
33. *Id.* § 1088(a)(11)(B), 124 Stat. at 2091 (amending 15 U.S.C. § 1681s-2(a)(8)).
34. *Id.* § 1088(a)(11)(A), 124 Stat. at 2090–91 (amending 15 U.S.C. § 1681s-2(a)(7)).
35. *Id.* § 1088(b)(1), 124 Stat. at 2092 (to be codified at 15 U.S.C. § 1681c-1 note) (amending FACT Act § 112(b)).
36. *Id.* § 1088(b)(3), 124 Stat. at 2092 (to be codified at 15 U.S.C. § 1681s-3 note) (amending FACT Act § 214(b)).
37. *Id.* § 1088(a)(2)(C), 124 Stat. at 2087 (amending the FCRA to substitute "Bureau" for "Commission," except in 15 U.S.C. §§ 1681m(e) and 1681w(a)(1)); *see also id.* § 1088(a)(10)(E), 124 Stat. at 2090 (amending 15 U.S.C. § 1681s(e)).
38. FACT Act, *supra* note 3, § 211, 117 Stat. at 1968–69 (codified as amended at 15 U.S.C.A. § 1681j(a) (West 2009 & Supp. 2010); Free Annual File Disclosures, 69 Fed. Reg. 35468 (June 24, 2004) (to be codified at 16 C.F.R. pts. 610 & 698) [hereinafter Original Free Reports Rule].
39. Pub. L. No. 111-24, 123 Stat. 1734 (2009).
40. *Id.* § 205(b), 123 Stat. at 1747 (to be codified at 15 U.S.C. § 1681j).
41. Free Annual File Disclosures, 75 Fed. Reg. 9726 (Mar. 3, 2010) (to be codified at 16 C.F.R. pt. 610) [hereinafter Amended Free Reports Rule].
42. *Id.* at 9746 (to be codified at 16 C.F.R. § 610.4(c)).
43. *Id.* at 9744–46 (to be codified at 16 C.F.R. §§ 610.2 & 610.4).

sumers could obtain a free annual file disclosure from each CRA on a single website.[44] The Amended Free Reports Rule prohibits CRAs from engaging in certain practices in connection with that website: CRAs may not (i) advertise products or services until after the consumer "has obtained his or her free annual disclosure";[45] (ii) display hyperlinks that would navigate the consumer away from the centralized source until after the consumer has obtained his or her free annual disclosure;[46] (iii) require that a consumer set up an account in connection with obtaining his or her file disclosure;[47] or (iv) ask or require a consumer to agree to terms or conditions in connection with obtaining his or her annual disclosure.[48]

Prevention of Deceptive Marketing of Free Reports

Congress enacted the CARD Act's new disclosure requirements out of a perceived need to dispel customer confusion caused by "free" credit report offers that are tied to an obligatory purchase and are not provided through the centralized source.[49]

Under the Amended Free Reports Rule, the offering or advertising of a "free credit report" triggers mandatory disclosures.[50] The Amended Free Reports Rule defines a "free credit report" as

> a file disclosure prepared by or obtained from, directly or indirectly, a nationwide consumer reporting agency . . . that is represented, either expressly or impliedly, to be available to the consumer at no cost if the consumer purchases a product or service, or agrees to purchase a product or service subject to cancellation.[51]

The definition excludes free credit scores that will not trigger the required disclosures.[52] The FTC clarified that advertising of bundled products that promote a free credit report in addition to other products and services may trigger the disclosures.[53] Additionally, a free credit report offered in connection with a free trial offer of a product or service may trigger the rule.[54]

44. Original Free Reports Rule, *supra* note 38, 69 Fed. Reg. at 35496 (to be codified at 16 C.F.R. § 610.2).

45. Amended Free Reports Rule, *supra* note 41, 75 Fed. Reg. at 9745 (to be codified at 16 C.F.R. § 610.2(g)(1)).

46. *Id*. (to be codified at 16 C.F.R. § 610.2(h)(1)).

47. *Id*. (to be codified at 16 C.F.R. § 610.2(h)(2)). The FTC clarified that a CRA may request that the consumer set up an account but cannot require it, and cannot make any such request until after the consumer has obtained the file disclosure. *Id*. at 9731, 9745 (to be codified at 16 C.F.R. § 610.2(g)(1)).

48. *Id*. at 9745 (to be codified at 16 C.F.R. § 610.2(h)(3)).

49. *Id*. at 9726–27.

50. *Id*. at 9746 (to be codified at 16 C.F.R. § 610.4(b)).

51. *Id*. at 9745 (to be codified at 16 C.F.R. § 610.4(a)(2)). A "file disclosure" is defined as "a disclosure by a consumer reporting agency pursuant to section 609 of the Fair Credit Reporting Act, 15 U.S.C. [§] 1681g." 16 C.F.R. § 610.1(b)(7) (2010).

52. Amended Free Reports Rule, *supra* note 41, 75 Fed. Reg. at 9732.

53. *Id*. at 9733.

54. *Id*. at 9732–33.

The Amended Free Reports Rule requires different disclosures based on the medium (television, radio, print, internet, or telemarketing) through which the free credit report is being marketed. For example, television and radio advertisements are required to disclose that "[t]his is not the free credit report provided for by Federal law,"[55] while telemarketers must state: "You have the right to a free credit report from AnnualCreditReport.com or 877-322-8228, the only authorized source under federal law."[56] These disclosures generally must be made in close proximity to the first mention of the free credit report,[57] and the rule sets forth other detailed requirements on the form of the disclosures, including prominence, language, readability, format, visibility, font size, color, and white space for disclosures.[58]

Risk-Based Pricing

The FACT Act added a provision to the FCRA directing the FTC and the Federal Reserve Board (the "Agencies") to issue joint rules requiring notice whenever a lender grants credit "on material terms that are materially less favorable than the most favorable terms available to a substantial proportion of consumers from or through that person."[59] The final rule, entitled the Fair Credit Reporting Risk-Based Pricing Regulations, was effective on January 1, 2011.[60] Generally, the final rule requires a risk-based pricing notice whenever a lender approves an applicant for credit subject to a higher interest rate than is offered to a substantial proportion of its borrowers for the same product type.[61]

The final rule adopts several key interpretations and clarifies the scope of application. For example, the notice requirements apply only in connection with consumer—not business or commercial—credit,[62] and the final rule limits the definition of "material terms"—those that trigger the disclosure—to the annual percentage rate ("APR"), excluding temporary initial rates and penalty rates.[63] The Agencies also clarified that the notice requirement falls to the person to whom an obligation is initially payable rather than an assignee or purchaser of credit.[64]

Determining Who Gets the Notice

The final rule permits lenders to determine who should receive the notice by directly comparing consumer loans on a case-by-case basis to determine whether

55. *Id.* at 9746 (to be codified at 16 C.F.R. § 610.4(b)(1) & (2)).
56. *Id.* (to be codified at 16 C.F.R. § 610.4(b)(6)).
57. *See, e.g., id.*
58. *Id.* at 9745–46 (to be codified at 16 C.F.R. § 610.4(a)).
59. FACT Act § 311(a), 15 U.S.C. § 1681m(h) (2006).
60. Fair Credit Reporting Risk-Based Pricing Regulations, 75 Fed. Reg. 2724, 2724 (Jan. 15, 2010) (to be codified at 12 C.F.R. pt. 222) [hereinafter Risk-Based Pricing Rule].
61. *Id.* at 2769 (to be codified at 16 C.F.R. § 640.3(a)).
62. *Id.* (to be codified at 16 C.F.R. § 640.1(a)(2)).
63. *Id.* (to be codified at 16 C.F.R. § 640.2(n)).
64. *Id.* at 2775 (to be codified at 16 C.F.R. § 640.6(b)).

a particular consumer has received an interest rate that is materially less favorable than the rate provided to a substantial proportion of the lender's other customers.[65] Recognizing that the direct comparison method will not be practical for most lenders, the final rule sets forth several alternate methods. Lenders are free to adopt different methods but must be consistent within a given product type, which is defined as "one or more credit products with similar features that are designed for similar purposes" such as secured credit cards, unsecured credit cards, student loans, new auto loans, used auto loans, fixed rate mortgage loans, and variable rate loans.[66]

Under the credit score proxy method, a lender complies with the rule by establishing a "cutoff credit score" and providing a notice to approved applicants whose score is less than the cutoff score.[67] A lender sets the cutoff score by analyzing a representative sample of its applicants to determine the score above which 40 percent of its applicants have higher scores and below which 60 percent have lower scores.[68] Where a lender uses the credit score proxy method and no score is available, the lender is required to provide a notice.[69]

Another method to determine who must receive the risk-based pricing notice is available to lenders who assign approved applicants to one of a discrete number of APR pricing tiers.[70] Under the tiered pricing method, the lender may provide the risk-based pricing notice to each consumer who is not assigned to the top pricing tier or tiers.[71] Lenders that offer four or fewer tiers must provide a notice to each approved consumer who does not qualify for the top, or lowest price, tier.[72] Lenders who offer five or more tiers must provide a notice to all approved applicants who are not assigned to those tiers that make up the top, or lowest priced, 30 percent to 40 percent of the total tiers.[73]

The final rule also provides a special method for credit card issuers to determine who must receive the risk-based pricing notice.[74] Under this provision, a card issuer may provide a notice to every applicant for a multiple rate offer who, based in whole or in part on the applicant's credit report, is granted credit for an APR that is higher than the lowest APR available for that offer.[75] Where the solicitation offers a single APR and the applicant is granted that APR, no notice is required.[76]

The final rule requires delivery of a notice not only at the outset of the relationship but also in connection with account reviews during the life of the account.[77]

65. *Id.* at 2771 (to be codified at 16 C.F.R. § 640.3(d)).
66. *Id.* at 2732, 2769–70 (to be codified at 16 C.F.R. § 640.3(b)).
67. *Id.* at 2770 (to be codified at 16 C.F.R. § 640.3(b)(1)).
68. *Id.* (to be codified at 16 C.F.R. § 640.3(b)(1)(iii)(A)).
69. *Id.* (to be codified at 16 C.F.R. § 640.3(b)(1)(iv)).
70. *Id.* at 2771 (to be codified at 16 C.F.R. § 640.3(b)(2)).
71. *Id.*
72. *Id.* (to be codified at 16 C.F.R. § 640.3(b)(2)(ii)).
73. *Id.* (to be codified at 16 C.F.R. § 640.3(b)(2)(iii)).
74. *Id.* (to be codified at 16 C.F.R. § 640.3(c)).
75. *Id.* (to be codified at 16 C.F.R. § 640.3(c)(1)).
76. *Id.* (to be codified at 16 C.F.R. § 640.3(c)(2)).
77. *Id.* (to be codified at 16 C.F.R. § 640.3(d)).

If a lender increases an existing customer's APR based in whole or in part on a review of the consumer's credit report and does not otherwise issue an adverse action notice, then the lender must provide the customer with a risk-based pricing notice.[78]

Content, Form, and Timing of the Notice

The central message of the risk-based pricing notice is that the terms offered "may be less favorable than the terms offered to consumers with better credit histories."[79] (For account reviews, the lender is required to notify the customer that his or her APR was increased "as a result" of a review of his or her account using information from a consumer report.[80]) Risk-based pricing notices must describe the type of information generally contained in credit reports, and must state that the lender set the terms based on a credit report and the consumer has a right to obtain a free report within sixty days of the notice.[81] The final rule requires that risk-based pricing notices be clear and conspicuous and provided to the consumer in oral, written, or electronic form.[82] The agencies have provided model forms, the use of which will provide lenders with a safe harbor.[83]

For closed-end credit, lenders must provide the notice before consummation of the transaction, but after communicating the approval to the consumer.[84] For open-end credit plans, lenders must provide the notice to the consumer before the first transaction under the plan, but after communicating the approval decision.[85] For account reviews, lenders must provide the notice at the time that the lender communicates the decision to increase the APR or, if no such notice is required by law, no later than five days after the effective date of the change in the APR.[86]

The agencies recognized that in-store credit presents special timing challenges. As such, the final rule provides that when open-end credit is granted "in person or by telephone for the purpose of financing the contemporaneous purchase of goods or services," any risk-based pricing notice or credit score disclosure notice (discussed below) may be provided upon the first mailing to the consumer after the approval, or within thirty days, whichever is sooner.[87]

Exceptions

No notice is required when a consumer applies for and receives specific material terms[88] or if the lender otherwise provides an adverse action notice.[89] The

78. *Id.*
79. *Id.* at 2772 (to be codified at 16 C.F.R. § 640.4(a)(1)(iii)).
80. *Id.* (to be codified at 16 C.F.R. § 640.4(a)(2)(iii)).
81. *Id.* at 2771–72 (to be codified at 16 C.F.R. § 640.4(a)(1) & (2)).
82. *Id.* at 2772 (to be codified at 16 C.F.R. § 640.4(b)(1)).
83. *Id.* (to be codified at 16 C.F.R. § 640.4(b)(2)).
84. *Id.* (to be codified at 16 C.F.R. § 640.4(c)(1)(i)).
85. *Id.* (to be codified at 16 C.F.R. § 640.4(c)(1)(ii)).
86. *Id.* (to be codified at 16 C.F.R. § 640.4(c)(1)(iii)).
87. *Id.* (to be codified at 16 C.F.R. § 640.4(c)(3)).
88. *Id.* at 2773 (to be codified at 16 C.F.R. § 640.5(a)).
89. *Id.* (to be codified at 16 C.F.R. § 640.5(b)).

Agencies have also used their statutory grant of authority to establish a number of exceptions.[90] For example, the final rule provides that lenders may provide all approved applicants with a notice that includes the applicant's credit score and certain additional information.[91] The rule refers to these as "credit score disclosure exception notices."[92] A lender using the credit score disclosure exception must give a notice to every consumer requesting credit for a given product for which the lender uses risk-based pricing, even those who would not otherwise receive a risk-based pricing notice.[93] Creditors, however, do not need to provide a credit score disclosure notice to a consumer if one of the other exceptions applies. For example, consumers who apply for and receive a specific rate or who receive an adverse action notice are not entitled to a notice.[94]

Generally, the credit score disclosure exception notice must disclose the score, basic information about credit scores and credit reports, the distribution of scores for consumers scored under the same model, and information about the consumer's right to obtain a free consumer report once during any twelve-month period.[95] Because these are not risk-based pricing notices, they do not give rise to an independent right to a free consumer report.[96] Like risk-based pricing notices, these notices must be clear and conspicuous,[97] and the agencies have made model forms available, appropriate use of which will provide safe harbor.[98] Unlike risk-based pricing notices, however, these notices must be provided in writing and must be "segregated" from other notices, except that they may be provided with the notice required by section 609(g) of the FCRA.[99] Generally, credit score disclosure notices must be provided to the consumer as soon as reasonably practicable after the credit score has been obtained but, in any event, at or before consummation in the case of closed-end credit or before the first transaction is made under an open-end credit plan.[100]

90. *Id.* at 2726; *see* 15 U.S.C. § 1681m(h)(6)(iii) (2006).

91. Risk-Based Pricing Rule, *supra* note 60, 75 Fed. Reg. at 2773–74 (to be codified at 16 C.F.R. § 640.5(d) & (e)).

92. *Id.* at 2727.

93. *Id.* at 2774–75 (to be codified at 16 C.F.R. § 640.5(d)(ii) & (e)(ii)); *see also id.* at 2732. Read literally, the final rule would suggest that a lender that uses the exception notice for "other credit" must do so universally for all credit product types offered. This, however, would be inconsistent with the Agencies' statement in connection with proxy methods in which they "recognize that the feasibility of these methods may vary for different types of credit products, and creditors may use different methods for different types of credit products." *Id.* at 2732.

94. *Id.* at 2743.

95. *Id.* at 2773–75 (to be codified at 16 C.F.R. § 640.5(d), (e) & (f)).

96. *Id.* at 2742.

97. *Id.* at 2773–75 (to be codified at 16 C.F.R. § 640.5(d)(2), (e)(2) & (f)(3)).

98. *Id.* at 2774–75 (to be codified at 16 C.F.R. § 640.5(d)(5), (e)(5) & (f)(5)).

99. *Id.* at 2773–75 (to be codified at 16 C.F.R. § 640.5(d)(2)(iii) & (iv), (e)(2)(ii) & (iii), and (f)(3)(ii) & (iii)).

100. *Id.* (to be codified at 16 C.F.R. § 640.5(d)(3), (e)(3) & (f)(4)).

2010 Privacy and Data Security Developments

*By Patricia E.M. Covington and Meghan Musselman**

Introduction

The year 2010 marked the end of a decade in which privacy and data security proved to be one of the most cutting-edge and constantly evolving areas of law. Legislatures and regulatory agencies at both the federal and state level worked to keep pace with technological advances and the need for consumer protection. The decade began with the enactment of the Gramm-Leach-Bliley Act ("GLB Act")[1] in November 1999, signifying the first time financial institutions were required to give consumers a notice detailing how personal information about them is collected and shared. The GLB Act also introduced the concept of safeguarding consumer information to non-bank financial institutions.[2] Safeguarding gained importance when California enacted its security breach notice law in 2003.[3] Almost every state followed California's lead and enacted its own security breach notice law.[4] Some states went further and enacted a host of other privacy and data security laws.[5]

Meanwhile regulators, particularly the Federal Trade Commission ("FTC"), vigilantly and zealously enforced new and existing laws against companies that

* Patricia E.M. Covington is a partner in the Maryland Office of Hudson Cook, LLP. She is Chair of the Privacy Subcommittee of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law and is the Liaison from the Committee on Consumer Financial Services to the American Bar Association Anti-Money Laundering Task Force. Meghan Musselman is a partner in the Maryland office of Hudson Cook, LLP. She is Vice Chair of the Legislation and Regulation Subcommittee of the Banking Law Committee of the Section of Business Law and a member of the Executive Council of the Federal Bar Association's Banking Law Committee.

1. Pub. L. No. 106-102, tit. V, 113 Stat. 1338, 1436 (1999) (codified as amended at 15 U.S.C. §§ 6801–6809 (2006)).

2. *See* 15 U.S.C. § 6801(b); *see also* Federal Trade Commission, Safeguards Rule, 16 C.F.R. pt. 314 (2010); Regulation P, 12 C.F.R. pt. 216 (2010).

3. *See* Cal. Fin. Code §§ 4050–4060 (West Supp. 2009).

4. Patricia E.M. Covington & Meghan Musselman, *Privacy and Data Security Developments Affecting Consumer Finance in 2008*, 64 Bus. Law. 533, 535–36 (2009) (in the 2009 *Annual Survey*) ("Virtually every state's security breach notice law contains some form of the [notice] provisions noted above. These provisions are derived from California's security breach notice law, which was the first of its kind. . . . Forty-four states now have some form of security breach notice law." (footnote omitted)).

5. *See* Patricia E.M. Covington & Meghan Musselman, *Recent Privacy and Data Security Developments*, 65 Bus. Law. 611, 618–19 (2010) (in the 2010 *Annual Survey*) ("The newest trend in state privacy legislation and regulation is the imposition of detailed safeguarding requirements."); *see also* Covington & Musselman, *supra* note 4, at 541–43.

either failed to safeguard consumer information adequately or did not keep their promises about how consumer information was maintained, used, or shared.[6] The decade ended on a slower pace, albeit with continued zealous enforcement of privacy and security laws and a pioneering law holding retailers liable for security breaches.[7] The current climate is one of study and reflection regarding what course privacy and data security law should take in the coming decade, particularly as it relates to online and mobile technologies.[8] There are hints of what is to come in proposed legislation and statements by FTC commissioners, clearly indicating that privacy, data security, and online activities are priorities.[9]

Online and Behavioral Marketing

The Importance of Online Marketing

Online and behavioral marketing is arguably the most rapidly developing area affecting privacy and data security. With the emergence of smartphones, social networking, and wireless internet, consumers spend increasingly more time online, changing how they behave and interact with the world.[10] Consumers maintain contact with friends and family through Facebook and Twitter, have constant access to the web on their smartphones, and rely on Global Positioning Systems ("GPS") to navigate the physical world. Online shopping is a "given," and online banking, including loan applications and online bill payment, is prevalent.[11] Using mortgage lending as an example, *National Mortgage News* reports that online

6. For a detailed discussion of the actions taken, see Covington & Musselman, *supra* note 5, at 613–15.

7. *See* Complaint, *In re* Twitter, Inc., No. 092 3093 (FTC filed Jan. 22, 2010), *available at* http://www.ftc.gov/os/caselist/0923093/100624twittercmpt.pdf [hereinafter Twitter Complaint]; 2010 Wash. Legis. Serv. ch. 151 (HB 1149) (West) (to be codified at Wash. Rev. Code § 19.255).

8. *See* Jon Leibowitz, Chairman, Fed. Trade Comm'n—Prepared Statement of the Federal Trade Commission on Consumer Privacy Before the Committee on Commerce, Science, and Transportation, United States Senate 2 (July 27, 2010), *available at* http://www.ftc.gov/os/testimony/100727consumerprivacy.pdf [hereinafter Prepared Statement] ("The FTC has a long track record of protecting consumer privacy. The Commission's early work on privacy issues dates back to its initial implementation in 1970 of the Fair Credit Reporting Act . . . which includes provisions to promote the accuracy of credit reporting information and protect the privacy of that information. With the emergence of the Internet and the growth of electronic commerce . . . the FTC expanded its focus to include online privacy issues. Since then, both online and offline privacy issues have been at the forefront of the Commission's agenda . . . .").

9. *See, e.g.*, David Vladeck, Dir., FTC Bureau of Consumer Prot.—Remarks to the International Association of Privacy Professionals: The Role of the FTC in Consumer Privacy Protection 3 (Dec. 8, 2009), *available at* http://www.ftc.gov/speeches/vladeck/091208iapp.pdf. ("We remain committed to addressing . . . consumer privacy harms, even as we reexamine existing privacy frameworks and identify new areas of concern to consumers.").

10. *See Led by Facebook, Twitter, Global Time Spent on Social Media Sites Up 82% Year Over Year*, Nielsen Wire (Jan. 22, 2010), http://blog.nielsen.com/nielsenwire/global/led-by-facebook-twitter-global-time-spent-on-social-media-sites-up-82-year-over-year/ ("[G]lobal consumers spent more than five and half [sic] hours on social networking sites like Facebook and Twitter in December 2009, an 82% increase from the same time last year . . . .").

11. *See* Fiserv, 2010 Billing Household Survey: Consumer Survey of Offline and Online Billing and Payment Practices 1 (2010), *available at* http://www.fiserv.com/RP_fiserv-2010-billing-household-survey(1).pdf ("As online penetration levels top 75% of all U.S. households, with 65% having

lending activities increased significantly from 2008 to 2009.[12] Loan production increased by 24 percent, the top ten loan providers increased online originations by 22 percent, and online retailers experienced a 90 percent increase in loan production.[13] Much of this growth is attributed to advances in mobile technology.[14] Consumer-centric businesses, including providers of financial products and services, want to capitalize fully on new technologies and consumers' desire for 24/7 (twenty-four hours a day, seven days a week) connectivity.[15] This is evident as businesses establish a presence on Facebook and Twitter.[16]

One way businesses are trying to capitalize on consumers' online presence and associated new technologies is by tracking consumers' online behaviors.[17] This practice is the foundation of targeted advertisements—ads pairing consumers with products and services in real time based on the consumers' online behaviors.[18] Many consumers are unaware that companies are logging their online activities and using them for marketing purposes; this disconnect raises privacy concerns and is a primary reason that Congress and the FTC have made behavioral advertising a priority.[19]

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broadband connectivity, Americans continue to grow more comfortable with transacting online—especially when it comes to online payment of recurring bills.").

12. *See* Anthony Garritano, *Mobile Technology Use Boosts Online Volume*, NAT'L MORTGAGE NEWS, June 18, 2010, at 1 ("According to survey figures compiled by National Mortgage News, online loan production increased 24% in 2009 from the prior year.").

13. *Id.* ("[O]nline loan production increased 24% in 2009 from the prior year. Online originations by the top 10 providers increased by 22%, but the biggest gains, by far, were achieved among online retailers which grew loan production by 90% during the same time frame.").

14. *Id.* ("The surge [in originations], many experts believe, was supported by mobile technology.").

15. *See id.* ("Mobile devices have long been part of our industry's corporate culture to optimize executives' time outside the office . . . ." (quoting Tyler Sherman, CEO of Motivity Solutions)).

16. *See generally* Steve Cocheo, *Billboards, Web, Twitter Spearhead Bank's Comeback*, AM. BANKING J., Sept. 2009, at 14, 14 ("Community banks venturing into social media remain a minority of the industry, and those using Twitter represent a smaller slice of the pie yet."); Alain Sherter, *Banking on Twitter and Facebook: Wells Fargo's Smart Social Networking Strategy*, BNET FIN. FOLLY (Apr. 1, 2010), http://www.bnet.com/blog/financial-business/banking-on-twitter-and-facebook-wells-fargo-8217s-smart-social-networking-strategy/4555.

17. *See generally* Julia Angwin, *The Web's New Gold Mine: Your Secrets*, WALL ST. J., July 30, 2010, at W1; Natasha Singer, *Shoppers Who Can't Have Secrets*, N.Y. TIMES, May 1, 2010, at BU5.

18. *See* Jon Leibowitz, Chairman, Fed. Trade Comm'n, Introductory Remarks at FTC Privacy Roundtable 1 (Dec. 7, 2009), *available at* http://www.ftc.gov/speeches/leibowitz/091207privacyremarks.pdf [hereinafter Introductory Remarks] ("Behavioral targeting is one of many ways that companies can use data, to try to tease out which consumers—or IP addresses, or uniquely identified cookies—are more likely to respond to a particular ad."); *see also* Emily Steel, *Marketers Watch as Friends Interact Online*, WALL ST. J., Apr. 15, 2010, at B5.

19. *See* Introductory Remarks, *supra* note 18, at 2 ("[T]here are both benefits to companies and consumers from targeting; such as more relevant advertising, and costs in terms of privacy. . . . Consumers have to grapple with this brave new world of information without analogies in their experience, and without a real understanding of the ways their information is handled or transferred."); *see also* David C. Vladeck, Dir., FTC Bureau of Consumer Prot., Remarks to the American Teleservices Association Washington Summit 10 (Apr. 27, 2010), *available at* http://www.ftc.gov/speeches/vladeck/100427ataspeech.pdf [hereinafter Teleservices Remarks] ("Let me now move . . . to a 'hot' area . . . consumer privacy and, more specifically, the privacy concerns related to behavioral advertising. Ensuring the privacy of consumers' personal information has been one of the FTC's top consumer protection priorities for more than a decade.").

Privacy Roundtables

At present, online and behavioral marketing practices are largely unregulated, both at the federal and state level.[20] However, the FTC has emphatically stated that behavioral privacy is a priority and that it is committed to protecting consumers in this area.[21] From late 2009 through the spring of 2010, the FTC held a series of Privacy Roundtables that explored new technologies used to collect and use consumer information, and how the resulting business practices, including behavioral marketing, affect consumer privacy.[22]

In his opening remarks at the inaugural Privacy Roundtable, FTC Chairman Jon Leibowitz said candidly that the FTC was not sure where it was headed, but would proceed with an open mind.[23] He also said that the notice and choice regime and the subsequent harm-based approach to enforcement have limited utility in the current marketplace.[24] In remarks made after the Privacy Roundtables concluded, Chairman Leibowitz explained that behavioral advertising implicates both consumer choice and consumer control—consumers are not aware that their habits are being tracked and then have no control over how that information is used.[25] He said the current notice and choice regime no longer works because consumers are not giving "informed" consent. Disclosures, he said, are drafted in legalese and buried in long and complex user agreements.[26] Nonetheless, as of this

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20. Richard Raysman & Peter Brown, *Tech Watch: Developments in Online Behavioral Advertising*, N.Y. L.J., June 8, 2010, at 5, *available at* http://www.law.com/jsp/article.jsp?id=1202461024572 ("There is no comprehensive privacy protection legislation in the United States that addresses the collection, storage, transmission, or use of personal information, but rather a patchwork of laws and regulations that peripherally touch on behavioral advertising.").

21. *See* Teleservices Remarks, *supra* note 19, at 10.

22. *Exploring Privacy: A Roundtable Series*, Fed. Trade Comm'n, http://www.ftc.gov/bcp/workshops/privacyroundtables/index.shtml (last visited Dec. 26, 2010) ("The Federal Trade Commission will host a series of . . . roundtable discussions to explore the privacy challenges posed by the vast array of 21st century technology and business practices that collect and use consumer data. Such practices include social networking . . . [and] online behavioral advertising. . . . The goal of the roundtables is to determine how best to protect consumer privacy while supporting beneficial uses of the information and technological innovation.").

23. Introductory Remarks, *supra* note 18, at 2–3 ("People have asked me what we expect to get from this roundtable, and where we're headed. I can honestly say: [W]e don't know. Our minds are open.").

24. *Id.* at 3 ("[T]he approaches we've tried so far—both the notice and choice regime, and later the harm-based approach—haven't worked quite as well as we would like.").

25. Jon Leibowitz, Chairman, Fed. Trade Comm'n—Where's the Remote? Maintaining Consumer Control in the Age of Behavioral Advertising, Address to the National Cable & Telecommunications Association 2 (May 12, 2010), *available at* http://www.ftc.gov/speeches/leibowitz/100512nctaspeech.pdf [hereinafter Where's the Remote] ("Behavioral advertising raises questions of consumer choice. Consumers often have no idea that advertisers are charting their personal information. . . . Behavioral advertising also raises questions of consumer control. Once advertisers capture personal data, consumers have no say in where or how securely it is stored. And they have little or no recourse if—or when—the data is stolen.").

26. *See id.* at 3 ("But today, few of us can comprehend the amount of personal data we've left open for capture on the Internet, and disclosure forms are most often written by lawyers, paid, it seems, by the syllable.").

writing, the FTC does not intend to regulate behavioral marketing—at least not in the near term. Chairman Leibowitz expressed "great hopes for self-regulation," referring to the Self-Regulatory Principles for Online Behavioral Advertising developed by several industry associations.[27] "So long as self-regulation is making forward progress," said Leibowitz, "the FTC is not interested in regulating [behavioral advertising]."[28]

While the FTC is not currently proposing to regulate behavioral marketing as such, it does intend to suggest ways that privacy can be improved, which could lead to federal legislation and regulation, and encourage stronger self-regulation principles. In testimony before Congress, the FTC identified the following priorities: (i) integrating privacy and data security measures into every business's procedures, systems, and technologies; (ii) simplifying online privacy choices for consumers; and (iii) improving transparency about how data is used.[29]

Data Pass

"Data pass" is a practice related to online marketing that recently surfaced as a hot-button issue. Data pass occurs during the checkout process when a consumer is making an online purchase.[30] While checking out, the consumer is offered a discount or reward offer; upon accepting the offer, the customer commits to membership or other recurring fees.[31] These membership offers come from third parties, not from the merchant from whom the consumer is making the purchase.[32] Many consumers do not realize that a third party is involved or that he or she has entered into an additional transaction.[33] The confusion arises because the consumer does not realize that the third party already has the consumer's credit card information, having obtained it from the merchant.[34] The concern is that consumers are committing to these transac-

27. *See id.* (citing Am. Ass'n of Adver. Agencies, Ass'n of Nat'l Advertisers, Council of Better Bus. Bureaus, Direct Mktg. Ass'n & Interactive Adver. Bureau, Self-Regulatory Principles for Online Behavioral Advertising (2009)). Examples of online behavioral advertising include online tracking and data collection. *See Privacy Implications of Online Advertising: Hearing Before the S. Comm. on Commerce, Science, and Transportation*, 110th Cong. 2 (2008) (statement of Lydia Parnes, Director, Bureau of Consumer Protection, Federal Trade Commission).

28. Where's the Remote?, *supra* note 25, at 3.

29. Prepared Statement, *supra* note 8, at 21, 22–25.

30. *See* Press Release, Visa, Visa Helps Protect Consumers from Deceptive Marketing (Apr. 27, 2010), *available at* http://corporate.visa.com/media-center/press-releases/press1011.jsp [hereinafter Visa Press Release] ("'[D]ata pass' usually involves a consumer shopping at a familiar retailer. At checkout, the consumer receives an offer for a discount or reward and does not realize it is from a different merchant and comes with unexpected monthly membership fees or recurring charges.").

31. *Id.*

32. *Id.*

33. *Id.*

34. Restore Online Shoppers' Confidence Act, S. 3386, 111th Cong. § 2(5) (2010) ("These third party 'post-transaction' offers were designed to make consumers think the offers were part of the initial purchase, rather than a new transaction with a new seller.").

tions under false pretenses, expecting that they must re-enter their payment information before they will become obligated on an additional transaction.[35] The Commerce Committee of the U.S. Senate reported in 2009 that 35 million consumers have paid $1.4 billion for marketing offers received through the use of data pass practices.[36]

There have been two significant developments over the past year relating to data pass. First, Visa announced a voluntary initiative that will prohibit internet merchants from providing cardholder information to third parties without the consumer's knowledge or active consent.[37] Visa has historically prohibited merchants from sharing account or transaction information with a third party not involved in the transaction.[38] Visa amended its rules to address more directly data pass by requiring retailers to ask consumers affirmatively to re-enter their credit card number before accepting a marketing offer from a third party.[39] The intent is to alert consumers that they are committing to an additional transaction that is separate and apart from the original transaction.

The second development was the introduction by Senator John D. Rockefeller IV (D-W. Va.) of legislation to regulate data pass. The Restore Online Shoppers' Confidence Act would prohibit a merchant from providing a consumer's account information to a third-party seller for purposes of a post-transaction sale.[40] The Act would also require a third-party seller to disclose clearly all material terms of the post-transaction sale, including the fact that the third-party seller is not affiliated with the initial merchant.[41] The third-party seller would also be required to obtain the consumer's express informed consent to charge the consumer's credit card, debit card, or bank account by requiring the consumer to: (i) enter her account number and contact information; and (ii) affirmatively act to demonstrate consent, such as by clicking on a confirmation number or checking a box to in-

35. *Id.* § 2(7) ("The use of a 'data pass' process defied consumers' expectations that they could only be charged for a good or service if they submitted their billing information, including their complete credit or debit card numbers.").

36. Office of Oversight & Investigations, Majority Staff, U.S. Senate Comm. on Commerce, Sci. & Transp., Aggressive Sales Tactics on the Internet and Their Impact on American Consumers ii (Nov. 19, 2009), *available at* http://commerce.senate.gov/public/index.cfm?p=Reports ("Affinion, Vertrue, Webloyalty and their e-commerce partners have earned over $1.4 billion in revenue. . . . Since 1999, Internet consumers have been enrolled more than 35 million times in Affinion, Vertrue, and Webloyalty's membership clubs."); *see also* Office of Oversight & Investigations, Majority Staff, U.S. Senate Comm. on Commerce, Sci. & Transp. Supplemental Report on Aggressive Sales Tactics on the Internet 1–2 (May 19, 2010), *available at* http://commerce.senate.gov/public/index.cfm?p=Reports.

37. *See* Visa Press Release, *supra* note 30; *see also* Press Release, U.S. Senator Jay Rockefeller, Senator Rockefeller Continues to Fight to Protect American Consumers and Combat Aggressive Sales Tactics on the Internet (Dec. 9, 2009), *available at* http://rockefeller.senate.gov/press/record.cfm?id=320462.

38. *See* Visa Press Release, *supra* note 30.

39. *Id.* ("To address the data-pass practice, merchants will now have to prompt consumers to re-enter their card information to accept a subsequent offer from a third-party merchant. This provides a clear signal to cardholders that a second purchase is being initiated.").

40. Restore Online Shoppers' Confidence Act, S. 3386, 111th Cong. § 3(b) (2010).

41. *Id.* § 3(a)(1) ("[B]efore obtaining the purchaser's billing information, the post-transaction third party seller has clearly and conspicuously disclosed to the purchaser all material terms of the transaction.").

dicate consent to the charge.[42] The Act left the Senate Committee on Commerce, Science, and Transportation on June 9, 2010.[43]

Privacy Notices

Last year's *Annual Survey* reported that the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, the FTC, the Commodity Futures Trading Commission, and the U.S. Securities and Exchange Commission (collectively "the Agencies") adopted model privacy notice forms that provide safe harbor protection for the GLB Act privacy notice requirement.[44] In April 2009, the Agencies released an online form builder that allows financial institutions to create their own privacy notice online.[45] The online form builder is available in four formats: (i) opt-out and affiliate marketing; (ii) opt-out and no affiliate marketing; (iii) no opt-out and affiliate marketing; and (iv) no opt-out and no affiliate marketing.[46] Both of the opt-out formats provide for opt-out by telephone or online; they do not allow for a mail-in opt-out option.

Data Security

FTC Enforcement Actions

As reported last year,[47] the FTC has, in recent years, increasingly used its enforcement authority under section 5 of the Federal Trade Commission Act ("FTC Act"),[48] which prohibits unfair and deceptive acts and practices in the area of data security.[49] This trend continued in 2010, as the FTC pursued enforcement actions under both the unfair and deceptive prongs of the FTC Act. The first was a landmark settlement with Twitter, Inc. ("Twitter"), a social networking site on which

42. *Id.* § 3(a)(2)(A), (B) ("[T]he post-transaction third party seller has received the express informed consent for the charge from the consumer whose credit card, debit card, bank account, or other financial account will be charged by—(A) obtaining from the consumer—(i) the full account number of the account to be charged; and (ii) the consumer's name and address and a means to contact the consumer; and (B) requiring the consumer to perform an additional affirmative action, such as clicking on a confirmation button or checking a box that indicates the consumer's consent to be charged the amount disclosed.").

43. *See S. 3386: Restore Online Shoppers' Confidence Act*, GovTrack, http://www.govtrack.us/congress/bill.xpd?bill=s111-3386 (last visited Dec. 26, 2010).

44. *See* Covington & Musselman, *supra* note 5, at 615 ("On November 17, 2009, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the National Credit Union Administration, the Federal Trade Commission, the Commodity Futures Trading Commission, and the U.S. Securities and Exchange Commission . . . adopted final model privacy notice forms pursuant to the GLB Act.").

45. Press Release, Fed. Trade Comm'n, Federal Regulators Release Model Consumer Privacy Notice Online Form Builder (Apr. 15, 2010), *available at* http://www.ftc.gov/opa/2010/04/glb.shtm.

46. *Final Model Privacy Form*, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/bankinforeg/privacy_notice_instructions.pdf (last visited Dec. 26, 2010).

47. *See* Covington & Musselman, *supra* note 5, at 613.

48. 15 U.S.C. § 45(a)(2) (2006).

49. *Id.*; *see also* Covington & Musselman, *supra* note 5, at 614–15.

users send brief updates called "tweets" to "followers." "Tweets" are sent in e-mails or text messages, and "followers" are those Twitter users who have requested to receive another user's tweets.[50] The Twitter settlement marks the first FTC enforcement action against a social networking service,[51] and demonstrates the FTC's commitment to staying relevant in the constantly changing technological marketplace. This settlement was based on the deceptive prong of the FTC Act.[52]

The FTC's complaint against Twitter stemmed from several incidents in 2009 where individuals gained unauthorized access to the Twitter system.[53] Those individuals accessed nonpublic tweets and other nonpublic user information, in addition to resetting user passwords.[54] A number of the reset passwords were posted on a website and used by others to send unauthorized tweets from the compromised accounts.[55] Perhaps the most well-known of these was a fraudulent tweet from President Barack Obama's account offering his followers a chance to win $500 in free gasoline in exchange for completing a survey.[56]

The FTC alleged that these intrusions occurred as a result of Twitter's failure to safeguard both its system and the nonpublic information contained in it, which violated its promises to users.[57] First, the FTC pointed to the privacy policy Twitter posted on its website, which stated: "Twitter is very concerned about safeguarding the confidentiality of your personally identifiable information. We employ administrative, physical, and electronic measures designed to protect your information from unauthorized access."[58] The FTC also pointed to other statements made on the Twitter website, particularly those describing privacy controls, for example: "Not everyone has to see your Twitter updates. Keep your Twitter updates private and approve your followers by protecting your profile . . . . Protected account owners control who is able to follow them, and keep their updates away from the public eye."[59]

The FTC charged that Twitter failed to live up to its promises in several respects, mostly because of inadequate policies and procedures concerning administrative passwords and access to information.[60] Almost all employees had administrative rights to all Twitter user accounts, giving them the ability to: (i) reset a user's account password; (ii) view a user's nonpublic tweets and other nonpublic user information; and (iii) send tweets on behalf of a user.[61] To exercise their admin-

50. *See* Twitter Complaint, *supra* note 7, ¶ 3.
51. Press Release, Fed. Trade Comm'n, Twitter Settles Charges that It Failed to Protect Consumers' Personal Information (June 24, 2010), *available at* http://www.ftc.gov/opa/2010/06/twitter.shtm.
52. *Id.*
53. Twitter Complaint, *supra* note 7, ¶ 12.
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.* ¶ 14.
58. *Id.* ¶ 10.
59. *Id.*
60. *Id.* ¶ 11.
61. *Id.* ¶ 7.

istrative rights, Twitter employees used their administrative passwords.[62] Twitter did not have policies and procedures for using the passwords.[63] Specifically, the FTC charged that the passwords were not required to be "hard to guess," nor were employees required to update their passwords periodically.[64] In addition, Twitter failed to disable an administrative log-in after a reasonable number of failed attempts.[65] These shortcomings, the FTC alleged, created vulnerabilities in the Twitter system, allowing intruders to gain easy access through the use of an automated password guessing tool that deciphered an employee's administrative password.[66]

In a consent order, Twitter agreed to develop and maintain "a comprehensive information security program . . . reasonably designed to protect the security, privacy, confidentiality, and integrity of nonpublic consumer information."[67] The consent order sets forth several requirements for the information security program, which largely track the FTC's Safeguards Rule.[68] Twitter is also required to have its information security program independently audited every other year for ten years.[69]

The FTC entered into a similar settlement with Dave & Buster's, Inc. ("Dave & Buster's"), a restaurant chain that operates throughout the United States and accepts payment by credit and debit card.[70] However, the FTC based this action on the unfairness prong of the FTC Act.[71] To process debit and credit card payments, Dave & Buster's collected the credit card number, expiration date, and electronic security code.[72] An intruder hacked into the Dave & Buster's computer system, installing unauthorized software and intercepting credit and debit card information for approximately 130,000 customers.[73] The FTC alleged that Dave & Buster's failed to take reasonable steps to protect sensitive personal information collected from customers, and that constituted unfair acts and practices.[74] The FTC identified the following as system vulnerabilities that led to the breach: (i) the failure to protect sufficiently against unauthorized access; (ii) the failure to conduct security investigations; (iii) the failure to restrict third-party access to its networks; (iv) the

62. *Id.*
63. *Id.* ¶ 11(a).
64. *Id.* ¶ 11(e).
65. *Id.* ¶ 11(c).
66. *Id.* ¶ 12(a).
67. Agreement Containing Consent Order, *In re* Twitter, Inc., No. 092 3093, § II (FTC June 24, 2010), *available at* http://www.ftc.gov/os/caselist/0923093/100624twitteragree.pdf [hereinafter Twitter Consent Order].
68. *Id.; see also* 16 C.F.R. § 314.4 (2010).
69. *See* Twitter Consent Order, *supra* note 67, § III.
70. *See In re* Dave & Buster's, Inc., No. 082 3153 (FTC June 8, 2010) (decision and order), *available at* http://www.ftc.gov/os/caselist/0823153/index.shtm [hereinafter Decision and Order].
71. *See* FTC Act § 5, 15 U.S.C. § 45 (2006).
72. Complaint ¶ 5, *In re* Dave & Buster's, Inc., No. 082 3153 (FTC June 8, 2010), *available at* http://www.ftc.gov/os/caselist/0823153/index.shtm.
73. *Id.* ¶ 8.
74. *Id.* ¶¶ 10–11.

failure to monitor outbound traffic on its networks to block unauthorized transfer of sensitive personal information; (v) the failure to limit access between in-store networks by using firewalls or other appropriate means; and (vi) the failure to limit access to its computer networks through wireless access points. Like Twitter, Dave & Buster's agreed to develop and maintain a comprehensive information security program and to have its information security program audited every other year for ten years.[75]

State Enforcement Actions

State attorneys general continue to enforce state data security laws actively. North Carolina Attorney General Roy Cooper is a prime example. Cooper entered into a consent order in May 2010 with urgent care center Prompt Med, P.A. ("Prompt Med"), settling charges that Prompt Med failed to dispose of patient records properly.[76] This action is notable because Prompt Med was held liable for the actions of a third-party service provider. In the course of its business as an urgent care center, Prompt Med collected personal information from its patients, including names, addresses, dates of birth, Social Security numbers, driver's license numbers, insurance account numbers, and personal health information.[77] Prompt Med hired an individual to dispose of those medical records, but instead of properly destroying the records, the individual disposed of about 600 files in a dumpster.[78] A third party discovered the records and turned them over to a local television station.[79] The television station notified the North Carolina Department of Justice, which charged Prompt Med with violations of North Carolina's Identity Theft Prevention Act.[80] This Act requires businesses to take reasonable measures to protect against unauthorized access to or use of personal information about North Carolina residents in connection with or after its disposal.[81] Under the resulting consent order, Prompt Med agreed to pay a total of $50,000 to the North Carolina Attorney General in the form of civil penalties, payments to the consumer protection enforcement fund, and attorney's fees and costs of the investigation and litigation.[82]

75. *See* Decision and Order, *supra* note 70, § II.

76. *See* North Carolina v. Prompt Med, P.A., No. 10cv008645 (Gen. Ct. Justice June 18, 2010) (consent judgment), *available at* http://ncdoj.gov/News-and-Alerts/News-Releases-and-Advisories/Related-Information/Prompt-Med-Consent-Judgment-Granted-051810.aspx [hereinafter Consent Judgment].

77. *Id.* at 2.

78. *Id.*

79. *Id.*

80. *Id.* at 2–3.

81. N.C. Gen. Stat. § 75-64(a) (2010) ("Any business that conducts business in North Carolina and any business that maintains or otherwise possesses personal information of a resident of North Carolina must take reasonable measures to protect against unauthorized access to or use of the information in connection with or after its disposal.").

82. *See* Consent Judgment, *supra* note 76, at 4–5.

Security Breach Notice Laws

Since most states have enacted security breach notice laws, the pace of new legislation has significantly slowed. The State of Washington, however, produced an interesting development, becoming the second state to adopt a retailer liability provision.[83] This law provides banks, which incur significant costs due to security breaches, with a remedy against retailers and payment processors that fail to protect against a security breach.[84] When a retailer's computer system is compromised and customer credit and debit card information is subjected to unauthorized access, the bank bears the burden of reissuing credit and debit cards, changing account passwords, and taking other steps to protect affected customers from identity theft.[85] The new Washington law provides that if a payment processor or business fails to take "reasonable care" to guard against unauthorized customer account information, the payment processor or business is liable to financial institutions for the costs incurred in connection with the breach.[86] A payment processor or business is not liable if the customer account information was encrypted at the time of the breach, or if the payment processor or business was certified as compliant with the Payment Card Industry Data Security Standards.[87] It will be interesting to see whether Washington's pioneer retailer liability law will provide momentum for other states that have struggled to pass similar bills in the past.

83. *See* 2010 Wash. Legis. Serv. ch. 151 (HB 1149) (West) (to be codified at Wash. Rev. Code § 19.255).

84. *Id.* § 2(3)(a) ("If a processor or business fails to take reasonable care to guard against unauthorized access to account information that is in [its] possession . . . and the failure is found to be the proximate cause of a breach . . . the processor or business is liable to a financial institution for reimbursement of reasonable actual costs related to the reissuance of credit cards and debit cards . . . .").

85. *Id.* § 1.

86. *Id.* § 2(3)(a).

87. *Id.* § 2(2)(a) ("Processors, businesses, and vendors are not liable under this section if (a) the account information was encrypted at the time of the breach, or (b) if the processor, business, or vendor was certified compliant with the payment card industry data security standards . . . .").

Auto Finance: Litigation and Legislative Developments Impacting Supplemental Products

*By David E. Gemperle and Kenneth J. Rojc**

Introduction

Motor vehicle dealers, lessors, banks, and finance companies continue to derive significant profits through the sale of products that promise to reduce the risk to the consumer in owning and financing a motor vehicle. These "Supplemental Products" have become a vital part of most consumer credit transactions and now include the following: debt cancellation products,[1] guaranteed asset protection ("GAP") waivers,[2] vehicle protection products,[3] and vehicle replacement

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* David E. Gemperle is an associate with Nisen & Elliott, LLC. Kenneth J. Rojc is a partner with Nisen & Elliott, LLC and manages the firm's automotive financial services legal practice. Messrs. Gemperle and Rojc are members of the Illinois Bar and the Legal Committee of the Association of Consumer Vehicle Lessors.

1. For example, "debt cancellation agreement" is defined under the Texas Finance Code as

> a retail installment contract term or a contractual arrangement modifying a retail installment contract term under which a retail seller or holder agrees to cancel all or part of an obligation of the retail buyer to repay an extension of credit from the retail seller or holder on the occurrence of the total loss or theft of the motor vehicle that is the subject of the retail installment contract but does not include an offer to pay a specified amount on the total loss or theft of the motor vehicle.

Tex. Fin. Code Ann. § 348.001(1-a) (West Supp. 2010).

2. For example, the Revised Code of Washington defines "guaranteed asset protection waiver" to mean

> a contractual agreement wherein a creditor agrees for a separate charge to cancel or waive all or part of amounts due that creditor on a borrower's finance agreement with that creditor in the event of a total physical damage loss or unrecovered theft of the motor vehicle, which agreement must be part of, or a separate addendum to, the finance agreement.

Wash. Rev. Code Ann. § 48.160.010(6) (West Supp. 2011). For a discussion of GAP waivers and their status under state law, see Mark S. Edelman, Robert A. Aitken, Thomas J. Buiteweg & Jeffrey P. Barringer, *Developments in Personal Property Finance: GAP Waivers—Is a Trend Toward Clarity Beginning?*, 64 Bus. Law. 487 (2009) (in the 2009 *Annual Survey*) (discussing the treatment of GAP waivers under state laws).

3. For example, Alabama defines "vehicle protection product" to mean

> a vehicle protection device, system, or service that is all of the following: a. Installed on or applied to a vehicle. b. Is designed to prevent loss or damage to a vehicle from a specific cause. c. Includes a written warranty. For purposes of this chapter, the term vehicle protection product shall include, without limitation, alarm systems, body part marking products, steering locks, window etch products, pedal and ignition locks, fuel and ignition kill switches, and electronic, radio, and satellite tracking devices. A vehicle protection product is not insurance for any purpose.

Ala. Code § 8-33-2(6) (LexisNexis Supp. 2010).

contracts.[4] With their popularity, Supplemental Products have been subject to increased scrutiny from consumers, government regulators, and Supplemental Product providers in the form of litigation challenges as well as legislative efforts to regulate and define the Supplemental Products as non-insurance. This survey addresses the litigation and legislative developments impacting Supplemental Products and focuses on the following issues: (i) Will Supplemental Products be classified by courts as "insurance"? (ii) Can a bank or finance company establish a list of approved providers of Supplemental Products without violating antitrust laws? (iii) Can a bank or finance company impose its own financial standards in approving or rejecting Supplemental Product providers? (iv) How have the newly enacted state statutes regulating Supplemental Products affected the classification and disclosure of these products in the context of consumer credit transactions?

Litigation

Insurance Classification

Insurance classification of Supplemental Products in the context of consumer credit transactions is a critical issue for several reasons. First, if a Supplemental Product is deemed insurance, then the premium paid for the product may be excluded from the finance charge only if the Regulation Z disclosure requirements are satisfied.[5] Second, the assignees of consumer credit transactions may be liable

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4. "A vehicle replacement contract covers the difference between [the] insurance check and the price of a brand-new vehicle—typically, the actual selling price or the sticker, whichever is lower." Donna Harris, *Car Totaled or Stolen? You Can Get New One; Coverage Goes GAP One Better—but Dealers, Lenders Are Slow to Embrace It*, Auto. News, July 19, 2010, at 22.

5. Federal Reserve Board Regulation Z, 12 C.F.R. pt. 226 (2010), and Regulation M, 12 C.F.R. pt. 213 (2010), implement the Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (codified as amended at 15 U.S.C. §§ 1601–1667f (West 2009 & Supp. 2010)), which applies to consumer credit sales of personal property for personal, family, and household use where the amount financed does not exceed $25,000, and to consumer leases for the use of personal property for personal, family, or household use for a period of time exceeding four months where the total contractual obligation does not exceed $25,000. *See* 15 U.S.C.A. §§ 1603(3), 1667(1) (West 2009).

Under Regulation Z,

> [c]harges or premiums paid for debt cancellation coverage for amounts exceeding the value of the collateral securing the obligation or for debt cancellation or debt suspension coverage in the event of the loss of life, health, or income or in case of accident may be excluded from the finance charge, whether or not the coverage is insurance, if the following conditions are met: (i) The debt cancellation or debt suspension agreement or coverage is not required by the creditor, and this fact is disclosed in writing; (ii) The fee or premium for the initial term of coverage is disclosed in writing. If the term of coverage is less than the term of the credit transaction, the term of coverage also shall be disclosed. . . . (iv) The consumer signs or initials an affirmative written request for coverage after receiving the disclosures specified in this paragraph, except as provided in paragraph (d)(4) of this section. Any consumer in the transaction may sign or initial the request.

12 C.F.R. § 226.4(d)(3) (2010).

In addition, if a product is classified as property insurance under state law, the

> [p]remiums for insurance against loss of or damage to property, or against liability arising out of the ownership or use of property, including single interest insurance if the insurer waives all right of subrogation against the consumer, may be excluded from the finance charge if the following conditions are met: (i) The insurance coverage may be obtained from a person of the consumer's

for improper disclosures related to Supplemental Products.[6] Third, parties involved in the sale or financing of Supplemental Products may need to be licensed as insurance agents or brokers.[7] As noted below, courts have recently addressed whether various Supplemental Products constitute insurance and have reached conflicting conclusions.

In *Seekamp v. Fuccillo Automotive Group, Inc.*,[8] the U.S. District Court for the Northern District of New York addressed a motion to dismiss a New York consumer motor vehicle purchaser's claim that an Auto Theft Security Discount ("ATSD") was actually insurance and that the plaintiff was harmed by the ATSD sale.[9] The plaintiff alleged that the sale of the ATSD violated the prohibition of New York General Business Law section 349 on deceptive acts and practices and that the dealer: (i) sold insurance without a license; (ii) failed to submit the ATSD policy rate to the New York State Insurance Department for approval; (iii) etched the VIN number in the vehicle's window prior to the sale of the ATSD; (iv) failed to obtain a license as an insurance carrier or insurance broker; (v) received an inappropriate commission from the Supplemental Product provider and failed to disclose the commission in breach of its fiduciary duties; (vi) misrepresented the ATSD as an anti-theft system and "not an insurance policy"; (vii) failed to include the ATSD in the "amount paid to insurance companies" in the TILA Itemization of Amount Financed; (viii) failed to include the ATSD in the finance charge as required in the absence of TILA insurance premium disclosures; and (ix) overcharged the consumer for an illegal insurance product.[10] These claims all depended on the classification of ATSD as "insurance."[11]

> choice, and this fact is disclosed. . . . (ii) If the coverage is obtained from or through the creditor, the premium for the initial term of insurance coverage shall be disclosed. If the term of insurance is less than the term of the transaction, the term of insurance shall also be disclosed.

Id. § 226.4(d)(2) (footnotes omitted).

Under Regulation M, if a product is classified as insurance under state law, the lessor is required to identify both the insurance and, "if the insurance is provided by or paid through the lessor, the types and amounts of coverage and the cost to the lessee." *Id.* § 213.4(o)(1).

6. *See, e.g.*, N. Shore Auto Fin., Inc. v. Block, 934 N.E.2d 381, 386 (Ohio Ct. App. 2010). The Ohio Court of Appeals held that a retail installment contract assignee violated the Truth in Lending Act ("TILA") by including a charge for the vendor's single interest insurance in the amount financed (rather than as a finance charge) without complying with the disclosure requirements of 12 C.F.R. § 226.4(d).

7. *See, e.g.*, N.Y. State Ins. Dep't Op. (Feb. 7, 2005) (Re: Auto Dealers/Gap and Credit Insurance), *available at* http://www.ins.state.ny.us/ogco2005/rg050212.htm ("An automobile dealer must be licensed as an insurance agent or broker to sell gap insurance on behalf of an insurer, but an automobile dealer may offer a gap waiver, as it is not considered doing insurance business as long as three conditions are met[:] . . . 'the assignee waives any and all obligations of the lessee or debtor for the gap amount, . . . the waiver applies only in the event of a total loss . . . [and] the charge to the lessee or debtor does not exceed the cost of the lessor or creditor gap insurance coverage[.]' " (quoting N.Y. Ins. Law § 1101(b) (McKinney 2000 & Supp. 2005))).

8. No. 1:09-CV-00018 (LEK/DRH), 2010 WL 980581 (N.D.N.Y. Mar. 15, 2010).

9. *Id.* at *1–2 ("Plaintiff alleges that Defendants misrepresented the ATSD agreement as a warranty when it was in fact an insurance policy. . . . Plaintiff further alleges that she and those similarly situated have suffered damages as a result of the Defendants' breach [of contract] and monetary benefit.").

10. *Id.* at *2.

11. *Id.* at *4 ("Plaintiff's claims are all contingent on whether ATSD is an insurance policy.").

The ATSD included a "Vehicle Identification Number Etch" service (a vehicle protection product, or "VPP") that purported to deter theft, and an agreement under which the defendant would provide a 10 percent discount on the purchase of a replacement vehicle (up to $2,000) if the vehicle was declared a total loss by the purchaser's insurer due to unrecovered theft or damage occurring after theft.[12] New York law does not address VPPs specifically; however, under the New York definition of an "insurance contract," the insurer is obligated to provide a monetary payment after the occurrence of a "fortuitous event," which is defined as "any occurrence or failure to occur which is . . . to a substantial extent beyond the control of either party."[13] The defendant argued that the ATSD was a warranty because a theft would occur only if the product failed.[14] The court disagreed, focusing on the plaintiff's allegation that the defendant was itself indemnified by an insurer which, according to a New York State Insurance Department opinion, indicated that the alleged "warranty" was insurance.[15] The *Seekamp* court held that the plaintiff alleged sufficient facts to establish that the ATSD was insurance and therefore denied the defendant's motion to dismiss.[16]

In *Tokuhisa v. Cutter Management Co.*,[17] the Hawaii Court of Appeals addressed a similar "vehicle theft registration system" ("VTR") and came to the opposite conclusion, holding that this type of product was not insurance.[18] The plaintiffs alleged that the defendant violated the state insurance code by unlawfully marketing and selling insurance without a proper license or certificate of authority, and that the attempt to profit from such actions violated the Hawaii prohibition on unfair and deceptive trade practices.[19] The VTR included a "warranty" stating that if the vehicle were stolen and not recovered within thirty days, the consumer would be paid $1,500 or $2,500 toward a replacement vehicle.[20] The defendant argued that the VTR window etch deterred theft because "[p]rofessional thieves recognize that vehicles with etched windows are traceable, glass is expensive to replace, and the automobile and etched glass are difficult to sell, even to illegal 'chop shops.'"[21] However, a Hawaii Police Department lieutenant testified that

12. *Id.* at *1.
13. N.Y. Ins. Law § 1101(a)(2) (McKinney 2006).
14. *Seekamp*, 2010 WL 980581, at *5.
15. *Id.* at *6 (citing N.Y. Ins. State Dep't Op. (Mar. 25, 2002) (Re: Anti-Theft Program), *available at* http://www.ins.state.ny.us/ogco2002/rg203251.htm ("The company's 'guarantee' or 'warranty' is neither a warranty nor a guaranty but is insurance, within the meaning of the Insurance Law. Whether the vehicle will be stolen is the triggering event under the agreement and the theft is to a substantial extent beyond the control of either the company or the consumer. By promising to provide a monetary benefit to the consumer upon the unrecovered theft or constructive total loss of the vehicle, the company would be providing to the consumer a benefit of pecuniary value upon the happening of a fortuitous event, and such agreement would constitute a contract of insurance.").
16. *Id.* at *7.
17. 223 P.3d 246 (Haw. Ct. App. 2009).
18. *Id.* at 255.
19. *Id.* at 248–49.
20. *Id.* at 253.
21. *Id.*

window etches were not used by the Hawaii Police Department and did not, in fact, deter theft.[22]

Unlike New York, Hawaii has a vehicle protection product act. Chapter 481R of the Hawaii Revised Statutes, entitled "Vehicle Protection Product Warrantors," directs the Hawaii Insurance Division to establish a regulatory regime patterned after the Hawaii Service Contracts Act.[23] "Vehicle protection product" is defined in Chapter 481R to mean "a product or system, which includes a written warranty, that is: (i) Installed or applied to a vehicle; and (ii) Designed to prevent loss or damage to a vehicle from a specific cause."[24]

In *Tokuhisa*, the plaintiff introduced testimony by the Hawaii Insurance Commissioner who stated that the VTR window etch product was incidental to an insurance policy, rather than a product designed to prevent loss accompanied by a warranty.[25] According to the Insurance Commissioner, the "VIN etch" service "is redundant to existing, more reliable vehicle identification systems," and VIN window etching "as a method of theft deterrence is at best . . . dubious."[26] Therefore, the Commissioner believed that because the product was unlikely to prevent loss, the "warranty" was a promise of indemnification only incidentally related to the functioning of a product and the VTR was insurance rather than a warranty.[27] However, notwithstanding the Insurance Commissioner's opinion regarding the purported "warranty," the court concluded that the VTR warranted against a "defect" causing the VIN window etch product to fail to deter theft, rather than indemnifying for the "fortuitous event" of theft itself.[28] Consequently, the VTR was not classified as insurance.[29]

Establishing a List of Approved Providers

Finance companies and banks may establish lists of approved providers for various Supplemental Products (e.g., an "Approved List").[30] In some instances, such finance companies and banks may be affiliated with Supplemental Product providers.[31] A recent case addressed antitrust claims against a finance company that placed its affiliated GAP[32] provider on its Approved List, but not the complainant. In *Midwest Agency Services, Inc. v. JP Morgan Chase Bank, N.A.*,[33] the U.S. District

22. *Id*. at 254.
23. *Id*.
24. Haw. Rev. Stat. Ann. § 481R-1 (LexisNexis 2009).
25. *Tokuhisa*, 223 P.3d at 254.
26. *Id*.
27. *Id*.
28. *Id*. at 255.
29. *Id*.
30. *See*, *e.g*., First Amended Complaint of Premier Dealer Services, Inc. ¶ 21, Midwest Agency Servs., Inc. v. JP Morgan Chase Bank, N.A., No. 2:09-CV-165 (E.D. Ky. Mar. 23, 2010), 2010 WL 2827582.
31. *Id*. ¶¶ 8–10, 11.
32. For a codification of the legal relationship between lender and dealer in a GAP waiver, see Wash. Rev. Code Ann. § 48.160.010(6) (West Supp. 2011).
33. No. 2-09-165-DCR, 2010 WL 935450 (E.D. Ky. Mar. 11, 2010).

Court for the Eastern District of Kentucky dismissed claims by Midwest Agency Services, Inc. ("Midwest") against Chase Auto Finance Corporation ("CAF") and related entities. Midwest sold GAP products that were financed under retail installment contracts.[34] Chase Auto Finance Corporation ("CAF") was a retail installment assignee and an affiliate of GAP provider Chase Insurance Agency.[35] CAF decided that it would only take assignment of retail installment contracts with charges for GAP coverage from GAP providers that were specifically approved by CAF.[36] Chase Insurance Agency and several unaffiliated GAP providers appeared on CAF's Approved List.[37] Midwest asserted claims against JP Morgan Chase, N.A. and CAF for violation of section 1 of the Sherman Act, violation of a Kentucky prohibition on unlawful "tying," and violation of the Bank Holding Company Act ("BHCA").[38]

The Sherman Act claim failed because the overall market was not injured by CAF's exclusion of Midwest from CAF's Approved List.[39] The Sherman Act allows standing only where an "antitrust" injury exists.[40] The court stated that "[t]he elements of an antitrust injury are: (1) the injury be the type of injury that antitrust laws were intended to prevent; and (2) the injury flows from the characteristic which makes the defendant's acts unlawful."[41] The total number of potential vendors was decreased at the time the Approved List was enforced, but there was no showing that this decrease had an effect on the overall competitive market.[42] Although Midwest was injured when it was left off the Approved List of providers, the court held that the injury was an individual injury and the market remained a competitive market.[43]

The claim under Kentucky law that CAF was "tying" sales together also failed, because: (i) CAF purchased retail installment contracts rather than selling retail installment contracts;[44] and (ii) consumers were not required to purchase GAP products, or to purchase GAP products from CAF.[45] Similarly, the court found that there was no prohibited "reciprocal and exclusive dealing" given that Chase Insurance was not the only provider on the Approved List and CAF would accept retail installment contracts without GAP coverage at all.[46] Finally, a BHCA claim for unlawful tying also failed because the consumers were not required to pur-

34. *Id*. at *2.
35. *Id*. at *1.
36. *Id*.
37. *Id*.
38. *Id*. at *3.
39. *Id*. at *3–4.
40. *Id*. at *3.
41. *Id*. (citing Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 489 (1977)).
42. *Id*. at *4.
43. *Id*.
44. *Id*. at *5 ("Defendants are the purchasers of the Credit Transactions. They are not selling a product in this situation, and, therefore, do not have the requisite selling power to coerce buyers to accept a tied product as required in a tying arrangement. . . . Defendants have created certain standards for Credit Transactions they would be willing to buy, which is not an antitrust violation.").
45. *Id*. at *6.
46. *Id*.

chase GAP products in order to obtain financing.[47] The holding in *Midwest Agency Services* suggests that a creditor adopting an Approved List or applying internally created standards for acceptable GAP providers should not be subject to Sherman Act section 1 or other antitrust claims as long as the GAP coverage is optional.

Imposing Financial Standards

In addition to maintaining a list of approved providers, creditors may establish financial criteria that a Supplemental Product provider must satisfy, such as criteria related to insurance of the Supplemental Product provider's obligations. In *Marathon Financial Insurance, Inc. v. Ford Motor Co.*,[48] the U.S. Court of Appeals for the Fifth Circuit addressed the issue of whether a finance company could impose financial stability standards in connection with service contracts financed with vehicle sales.[49] In 2004, Ford Motor Credit Company ("FMCC") decided that, as of January 1, 2005, it would no longer finance purchases of vehicle service contracts unless the service contract provider was itself insured by an insurer with an A.M. Best stability rating of A minus or better.[50] The plaintiff, Marathon Financial Insurance Company, Inc. ("Marathon"), failed to obtain the requisite A.M. Best rating, and Automotive Professionals, Inc. ("API"), one of its customers, switched to another insurer.[51] FMCC's affiliated service contract provider, Ford Motor Service Company, was insured by another Ford Motor Company subsidiary, American Road Insurance Company, which had an acceptable rating.[52] Marathon filed suit in the U.S. District Court for the Eastern District of Texas alleging violation of Illinois law for tortious interference based on the premise that by imposing the A.M. Best standard, FMCC improperly interfered with Marathon's contractual relationship with API in order to increase the sales of Ford Motor Service Company contracts.[53]

Under Illinois tortious interference law, if the defendant corporation has acted in the interest of the corporation and its shareholders (that is, its actions were "privileged"), the plaintiff must show that the action was not "justified."[54] An action is not "justified" under Illinois tortious interference law if the conduct is "totally unrelated or even antagonistic to the interest which gave rise to defendant's privilege."[55] Marathon failed to offer evidence that the A.M. Best rating require-

47. *Id*. at 7–8. In the context of the BHCA the following are required to establish unlawful tying: (i) the bank imposed an anticompetitive arrangement by conditioning an extension of credit upon the borrower obtaining additional credit or services from the bank; (ii) the arrangement was unusual or nontraditional in the banking industry; and (iii) the practice benefited the bank. *See*, *e.g*., Highland Capital, Inc. v. Franklin Nat'l Bank, 350 F.3d 558, 565 (6th Cir. 2003).

48. 591 F.3d 458 (5th Cir. 2009).

49. *Id*. at 461.

50. *Id*. at 462.

51. *Id*.

52. *Id*. at 461.

53. *Id*.

54. *Id*. at 464 (citing HPI Health Care Servs., Inc. v. Mt. Vernon Hosp., Inc., 545 N.E.2d 672, 677 (Ill. 1989)).

55. *Id*.

ment was antagonistic to, or unrelated to, the interests of FMCC's shareholders and summary judgment was affirmed in favor of FMCC.[56] This case supports the ability of creditors to rely on the business judgment of the creditor's officers and directors in determining appropriate financial responsibility and other standards that must be satisfied by Supplemental Product providers.

State Statutes

Gap Waivers

In late 2009 and 2010, Louisiana,[57] Michigan,[58] Nebraska,[59] Utah,[60] and Washington[61] enacted GAP waiver laws classifying GAP waivers as non-insurance products and establishing disclosure, reporting, and consumer protection requirements for such products. These statutes generally contain four common elements. First, except for Louisiana,[62] a GAP waiver is a part of, or a separate addendum to, the finance agreement (i.e., defined as a contractual agreement wherein a creditor agrees, for a separate charge, to cancel or waive all or part of amounts due on a borrower's finance agreement in the event of a total physical damage loss or unrecovered theft of a motor vehicle).[63] Again, except for Louisiana,[64] the statutes specifically exclude debt cancellation contracts and debt suspension agreements

56. *Id.* at 468.

57. 2010 La. Sess. Law Serv. Act No. 374 (H.B. 452) (West) (to be codified at La. Rev. Stat. Ann. §§ 6:969.5, 6:969.6, 6:969.35, 6:969.42, 6:969.51–.54) [hereinafter Louisiana Gap Waiver Act].

58. *See* Mich. Comp. Laws Ann. §§ 492.25–.33 (West Supp. 2010).

59. *See* Neb. Rev. Stat. Ann. §§ 45-1101 to -1107 (LexisNexis Supp. 2010).

60. *See* Utah Code Ann. §§ 31A-6b-101 to -401 (LexisNexis 2010).

61. *See* Wash. Rev. Code Ann. §§ 48.160.001–.080 (West Supp. 2011).

62. "Gap Coverage" was already defined in Louisiana prior to enactment of the new Louisiana law as follows:

> "GAP coverage" means a contract or insurance policy that covers a consumer's deficiency balance between the net payoff of the consumer's loan [or] retail installment sales contract at the time of a loss and the amount paid by the consumer's primary insurance after a vehicle is deemed a total loss due to any direct or accidental physical damages or unrecovered theft which may be in the form of the following: (a) Guaranteed auto protection offered by a property and casualty company licensed and regulated by the Department of Insurance. (b) Guaranteed auto protection offered by a property residual value insurer licensed and regulated by the Department of Insurance. (c) Debt waiver or debt forgiveness agreements issued by a lender licensed or regulated by the commission.

La. Rev. Stat. Ann. § 6:969.6(19) (Supp. 2010).

63. Mich. Comp. Laws Ann. § 492.23(g) (West Supp. 2010); Neb. Rev. Stat. Ann. § 45-1103(7) (LexisNexis Supp. 2010); Utah Code Ann. § 31A-6b-102(2)(f) (LexisNexis 2010); Wash. Rev. Code Ann. § 48.160.010(6) (West Supp. 2011).

64. The already enacted "Gap Coverage" definition in Louisiana includes contracts offered by property and casualty companies, insurers, and licensed lenders. Such licensed lenders would not include national banks. La. Rev. Stat. Ann. § 9:3560(A) (2009) ("[T]he following persons shall be exempt from the consumer loan licensing requirements under this part: (1)(a) A bank, savings and loan association, or similar financial institution organized, certified, and supervised by an agency of either the United States of America or the state of Louisiana pursuant to the banking, currency and related laws of the United States of America or the state of Louisiana.").

offered by national banks.[65] Second, the consumer is provided a thirty or ninety day "Free Look Period" during which he or she may cancel the GAP waiver and obtain a refund of the unearned portion of the purchase price (as in an insurance contract).[66] Third, in cases of cancellation for consumer default, the refund may be paid to the creditor.[67] Fourth, the GAP waiver must disclose the following: (i) the name and address of the initial creditor and the borrower at the time of sale, and the identity of any administrator if different from the creditor; (ii) the purchase price, as well as the requirements for protection, conditions, or exclusions associated with the GAP waiver; (iii) the procedure to obtain benefits, including telephone and mail contact information; (iv) the conditions for cancellation after the Free Look Period and procedures for obtaining a refund on early cancellation, which may require ninety days notice; (v) the method of refund calculation; and (vi) a statement that the GAP waiver is not required as a condition of the extension of credit.[68]

Beyond these common provisions, some states also enacted additional GAP legislation. In Louisiana, the Free Look Period is thirty days rather than ninety days and in a separate new act, Louisiana prohibits sales finance licensees from coercing motor vehicle dealers to sell a particular company's GAP waivers.[69] Michigan separately amended its Motor Vehicle Sales Finance Act, which governs motor vehicle retail installment sales, and its Retail Installment Sales Act, which governs retail installment sales of motorcycles, boats, and other personal property, to require disclosure of the cost of a GAP waiver and to provide that the GAP waiver disclosure may be included as part of, or as an addendum to, the retail installment sales contract.[70] The State of Washington requires registration of anyone who markets or sells GAP products, with certain exceptions.[71]

65. Mich. Comp. Laws Ann. § 492.33(1)(b) (West Supp. 2010); Neb. Rev. Stat. Ann. § 45-1102(2)(b) (LexisNexis Supp. 2010); Utah Code Ann. § 31A-6b-103(3)(b) (LexisNexis 2010); Wash. Rev. Code Ann. § 48.160.001(2)(b) (West Supp. 2011).

66. Louisiana Gap Waiver Act, *supra* note 57, § 1 (to be codified at La. Rev. Stat. Ann. § 6:969.53(A)); Mich. Comp. Laws Ann. § 492.23(f) (West Supp. 2010); Neb. Rev. Stat. Ann. § 45-1103(6) (LexisNexis Supp. 2010); Utah Code Ann. § 31A-6b-303(2)(a) (LexisNexis 2010); Wash. Rev. Code Ann. § 48.160.010(5) (West Supp. 2011).

67. Louisiana Gap Waiver Act, *supra* note 57, § 1 (to be codified at La. Rev. Stat. Ann. § 6:969.53(C)); Mich. Comp. Laws Ann. § 492.27(c) (West Supp. 2010); Neb. Rev. Stat. Ann. § 45-1105(3) (LexisNexis Supp. 2010); Utah Code Ann. § 31A-6b-303(2)(b) (LexisNexis 2010); Wash. Rev. Code Ann. § 48.160.050(8) (West Supp. 2011).

68. Louisiana Gap Waiver Act, *supra* note 57, § 1 (to be codified at La. Rev. Stat. Ann. § 6:969.54); Mich. Comp. Laws Ann. § 492.27 (West Supp. 2010); Neb. Rev. Stat. Ann. § 45-1105 (LexisNexis Supp. 2010); Utah Code Ann. § 31A-6b-302(1), (2) (LexisNexis 2010); Wash. Rev. Code Ann. § 48.160.050 (West Supp. 2011).

69. Louisiana Gap Waiver Act, *supra* note 57, § 1 (to be codified at La. Rev. Stat. Ann. § 6:969.6(34)); 2010 La. Sess. Law Serv. Act No. 258, § 1 (H.B. 591) (West) (to be codified at La. Rev. Stat. Ann. § 6.969.24.1(A)).

70. *See* Mich. Comp. Laws Ann. §§ 492.113(2)(e), 445.853(d)(6) (West Supp. 2010).

71. Wash. Admin. Code § 284-160-030 (2010) ("Any person offering or selling guaranteed asset protection waivers to residents of the state of Washington or borrowers in the state of Washington, or acting as an obligor for guaranteed asset protection waivers sold to residents of this state, must register with the commissioner as required by RCW 48.160.020 unless: (1) The person is exempt under RCW 48.160.001(2); (2) The person is a retail seller of motor vehicles assigning: (a) More than eighty-five

Debt Cancellation Agreements

Texas enacted legislation effective September 1, 2009, which classifies "debt cancellation agreements"[72] as non-insurance and permits inclusion of a charge for the product in a Texas motor vehicle retail installment sales contract if the retail seller provides a separate notice that the debt cancellation agreement is not required as a condition of the extension of credit.[73] The Texas Office of the Consumer Credit Commissioner has promulgated extensive regulations implementing the legislation.[74] These Texas debt cancellation rules differ from the GAP waiver laws in Louisiana, Michigan, Nebraska, Utah, and Washington noted above in that: (i) Texas mandates maximum rates based on the type of debt cancellation agreement;[75] (ii) Texas requires a notice separate from the motor vehicle retail installment sales contract and the debt cancellation agreement to be provided to the purchaser;[76] and (iii) Texas extensively regulates the provisions in the debt cancellation agreement based on the type of debt cancellation agreement.[77]

Conclusion

In 2010, state legislatures continued the trend of adopting statutes defining Supplemental Products as non-insurance. Nearly all of the new GAP waiver statutes followed a common scheme. However, the Texas debt cancellation statute and its implementing regulations include unique provisions regarding pricing, product classification, and permissible provisions. Notwithstanding the statutory attempts to classify Supplemental Products as non-insurance, courts are still hearing challenges regarding this issue from consumers and government regulators and are sometimes reaching different conclusions. Supplemental Products that do not fit clearly within an insurance safe harbor have been held to be insurance. Banks and creditors that finance Supplemental Products will need to examine

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percent of guaranteed asset protection waiver agreements within thirty days of such agreements' effective date; and (b) One hundred percent of guaranteed protection waiver agreements within forty-five days of each agreement's effective date; or (3) The person is an insurer authorized to transact insurance business in Washington state."). Section 48.160.001(2) of the Revised Code of Washington exempts insurers and "federally regulated financial institutions operating under 12 C.F.R. Part 37 of the office of the comptroller of the currency regulations or credit unions operating under 12 C.F.R. § 721.3(g) of the national credit union administration regulations, or state regulated banks, credit unions, or financial institutions operating pursuant to chapter 63.14 RCW, and consumer loan companies operating pursuant to chapter 31.04 RCW." WASH. REV. CODE ANN. § 48.160.001(2)(b) (West Supp. 2011).

72. *See* TEX. FIN. CODE ANN. § 348.001(1-a) (West Supp. 2010).

73. TEX. FIN. CODE ANN. § 348.124(b) (West Supp. 2010) ("A debt cancellation agreement is not considered an insurance product."); *id.* § 348.124(d) ("In addition to other disclosures required by state or federal law, the retail seller shall provide to the retail buyer a separate notice in connection with the retail installment contract stating that the retail buyer is not required to accept or provide a debt cancellation agreement in order to purchase the motor vehicle under a retail installment contract.").

74. *See* 35 Tex. Reg. 1959 (Mar. 5, 2010).

75. 7 TEX. ADMIN. CODE § 84.308(e) (2010).

76. *See id.* § 84.308(b)(1).

77. *See id.* § 84.308(c).

closely developing litigation trends and statutes to avoid liability for improper disclosure in the context of consumer credit contracts. Furthermore, recent case law has provided valuable guidance to banks and creditors as to how to develop Supplemental Product programs to avoid antitrust violations and how to establish criteria for approved lists of Supplemental Product vendors.

Current Developments in Bank Deposits and Payment Systems

*By Ryan S. Stinneford, Laura Hobson Brown, and Candace Modlin Davis**

Introduction

This survey summarizes recent legal and regulatory developments affecting bank deposits and payment systems, focusing on: (i) developments involving deposit account overdrafts, including amendments to existing regulations, proposed regulatory guidance, and recent litigation; (ii) regulatory and legislative developments with respect to deposit insurance; (iii) debit card interchange and network rules; and (iv) new disclosures and restrictions for stored value card products.

Overdraft Rules

Regulatory Amendments

Last year's survey[1] reported on 2010 amendments to Federal Reserve Board ("FRB") Regulations E[2] and DD[3] that significantly impacted both a depository institution's ability to assess overdraft fees and the overdraft-related disclosures that it must provide to its consumer depositors. Subsequently, the FRB provided additional guidance for complying with the new rules by amending Regulations E and DD and the respective Official Staff Commentary ("Commentary").[4]

Regulation E Final Rule

Regulation E prohibits a depository institution from charging a fee for paying an automated teller machine ("ATM") or one-time debit card transaction that

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* Ryan S. Stinneford is a partner in the Banking & Financial Services Practice Group of Pierce Atwood LLP and Chair of the Deposit Products and Payment Systems Subcommittee of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law. Laura Hobson Brown is a member in the Banking Law and Consumer Financial Services Practice Groups of McGlinchey Stafford PLLC and Vice Chair of the Deposit Products and Payment Systems Subcommittee of the Committee on Consumer Financial Services. Candace Modlin Davis is Assistant General Counsel at Capital One Financial.

1. Ryan S. Stinneford, Laura Hobson Brown & Candace Modlin Davis, *Current Developments in Bank Deposits and Payment Systems*, 65 Bus. Law. 629, 634 (2010) (in the 2010 *Annual Survey*).

2. 12 C.F.R. pt. 205 (2010).

3. 12 C.F.R. pt. 230 (2010).

4. Electronic Fund Transfers, 75 Fed. Reg. 31665 (June 4, 2010) (to be codified at 12 C.F.R. pt. 205); Truth in Savings, 75 Fed. Reg. 31673 (June 4, 2010) (to be codified at 12 C.F.R. pt. 230).

overdraws a consumer's account unless the consumer has consented to the overdraft service.[5] The amended Regulation E Commentary clarifies that the fee prohibition applies to an institution with a policy of declining ATM and one-time debit card transactions when at the time of the authorization request the consumer's account has insufficient funds to cover the transaction.[6] While an institution with such a policy need not comply with the opt-in requirement, it may not assess an overdraft fee for paying an ATM or one-time debit card transaction that overdraws the account.[7] An institution must confirm the consumer's opt-in choice in writing before charging overdraft fees,[8] and overdraft fees are permitted only on transactions paid after confirmation has been mailed or delivered.[9]

The amended Commentary also clarifies that a negative balance fee may not be assessed if the negative balance is attributable solely to an ATM or one-time debit card transaction, unless the consumer has opted in to the institution's overdraft service.[10] However, such a fee is permissible if the negative balance is attributable at least in part to another type of transaction that is not subject to the overdraft fee prohibition.[11]

Regulation DD Final Rule

Effective as of October 1, 2010, amended Regulation DD requires a depository institution to use the term "Total Overdraft Fees" when disclosing the total dollar amount of all fees imposed on the account for the calendar year-to-date for paying checks or other items when there are insufficient funds and the account becomes overdrawn.[12] An institution disclosing account information to a consumer through an automated system must disclose a balance that does not include additional amounts that the institution may provide to cover an overdraft item.[13] The disclosed balance, however, may include funds that are transferred from another account pursuant to a retail sweep program.[14]

Additional Agency Guidance

The Office of Thrift Supervision ("OTS") and the Federal Deposit Insurance Corporation ("FDIC") individually published additional guidance regarding over-

5. 12 C.F.R. § 205.17(b)(1) (2010).
6. Electronic Fund Transfers, 75 Fed. Reg. at 31672.
7. *Id.*
8. 12 C.F.R. § 205.17(b)(1)(iv) (2010).
9. Electronic Fund Transfers, 75 Fed. Reg. at 31672.
10. *Id.*
11. *Id.*
12. Truth in Savings, 75 Fed. Reg. 31673, 31676 (June 4, 2010) (to be codified at 12 C.F.R. pt. 230). The remaining provisions of the final rule were effective July 6, 2010. *Id.* at 31673.
13. 12 C.F.R. § 230.11(c) (2010).
14. Truth in Savings, 75 Fed. Reg. at 31676. Retail sweep programs allocate and transfer funds between a transaction subaccount and a savings subaccount in order to maximize the savings subaccount's balance; however, the consumer's periodic statement reflects a single account balance. *Id.* at 31674–75.

draft payment programs to supplement and update the agencies' 2005 existing overdraft guidance.[15] Both the OTS's proposed Supplemental Guidance on Overdraft Programs[16] and the FDIC's supervisory guidance[17] indicate that supervised institutions should take additional specified actions with respect to their automated overdraft payment programs that exceed the requirements of Regulations E and DD.

Overdraft Litigation

Gutierrez v. Wells Fargo Bank, N.A.

Last year's survey[18] reported on an early proceeding in *Gutierrez v. Wells Fargo Bank*, *N.A.*,[19] a case that was recently decided by the U.S. District Court for the Northern District of California.[20] In *Gutierrez*, the plaintiffs challenged several of Wells Fargo's deposit account posting practices: (i) high-to-low ("HTL") posting; (ii) commingling during posting of debt card purchases with checks and automated clearing house transactions; and (iii) deployment of a "shadow line" to authorize debit card purchase overdrafts.[21] The court found these practices to be unfair under California law because the bank did not act in good faith, which the court concluded is required by the California Commercial Code and the implied covenant of good faith and fair dealing.[22] According to the court, the practices were "motivated by avarice at the depositor's expense," and no credible evidence

15. *See* Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 9127 (Feb. 24, 2005); *see also* Guidance on Overdraft Protection Programs, 70 Fed. Reg. 8428 (Feb. 18, 2005).

16. Supplemental Guidance on Overdraft Protection Programs Proposal, 75 Fed. Reg. 22681 (Apr. 29, 2010). Simultaneously with adoption of its Supplemental Guidance on Overdraft Programs, the OTS announced its issuance of a cease and desist order and the assessment of $400,000 in civil money penalties against Woodforest Bank of Refugio, Texas ("Woodforest"). Woodforest also agreed to refund more than $12 million to consumer depositors who were charged excessive fees for overdraft protection. *See* Press Release, Office of Thrift Supervision, Woodforest Bank to Pay Penalty and Restitution for Overdraft Protection Program Unfair to Consumers (Apr. 23, 2010) (10-018), *available at* www.ots.treas.gov/?p=NewsEvents. On October 8, 2010, the Comptroller of the Currency announced a settlement agreement with Woodforest National Bank of The Woodlands, Texas ("Woodforest National"), in which Woodforest National agreed to pay $32 million in reimbursements to consumers who were harmed by the bank's assessment of excessive overdraft fees and improper marketing of its overdraft program. Woodforest National Bank was also required to pay a civil money penalty of $1 million. *See* Press Release, Office of the Comptroller of the Currency, OCC, Woodforest National Bank Enter Agreement to Reimburse Consumers (Oct. 8, 2010) (NR 2010-122), *available at* www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-122.html.

17. Fed. Deposit Ins. Corp., FDIC Overdraft Payment Supervisory Guidance (Nov. 24, 2010) (FIL-81-2010), *available at* http://www.fdic.gov/news/news/financial/2010/fil10081b.pdf.

18. Stinneford, Brown & Davis, *supra* note 1, at 634.

19. No. C 07-05923 WHA, 2008 WL 4279550 (N.D. Cal. Sept. 11, 2008).

20. No. C 07-05923, 2010 WL 3155934 (N.D. Cal. Aug. 10, 2010); *cf*. Stinneford, Brown & Davis, *supra* note 1, at 634 (reporting on *Hassler v. Sovereign Bank*, 644 F. Supp. 2d 509 (D.N.J. 2009), where on similar facts, the court granted Sovereign's motion to dismiss for failure to state a claim). The decision in *Hassler* was recently affirmed by the U.S. Court of Appeals for the Third Circuit. *See* Hassler v. Sovereign Bank, 374 F. App'x 341 (3d Cir. 2010).

21. *Gutierrez*, 2010 WL 3155934, at *2–4.

22. *Id*. at *44–46.

pointed to any other rationale.[23] The court rejected as a "post-hoc rationalization" Wells Fargo's argument that customers prefer HTL posting.[24]

The *Gutierrez* court also found that Wells Fargo's practices constituted fraud under California statutory law,[25] which requires only that consumers are "likely to be deceived."[26] The court determined that this standard was met because, among other reasons: (i) the fee schedule did not disclose the HTL posting or its impact; (ii) the disclosures on posting order were buried in an account agreement of approximately sixty pages; (iii) the disclosures, which provided that "the Bank may, if it chooses, post [transactions] . . . in the order of highest dollar amount to the lowest dollar amount," would leave reasonable consumers with the impression that the bank had not yet decided to post transactions in this manner; and (iv) various customer communications, including marketing materials, would leave reasonable consumers with the impression that transactions would be posted in chronological order.[27]

The *Gutierrez* court rejected, among other arguments, Wells Fargo's preemption defense, concluding that the HTL posting was not a "pricing" decision[28] subject to federal preemption and, even if it were, (i) Wells Fargo did not use the Office of the Comptroller of the Currency's four-factor decision-making process when establishing fees and charges,[29] and (ii) state law still regulates Wells Fargo's conduct, which raises issues of unfair and deceptive practices.[30]

Multi-District Litigation—*In re* Checking Account Overdraft Litigation

In a recent order ruling on an omnibus motion to dismiss multiple debit card HTL posting-related complaints against numerous major U.S. banks,[31] the court dismissed limited claims under certain state laws,[32] but denied dismissal of many other claims, including those based upon:

- Breach of contract for implied covenant of good faith and fair dealing.[33] The court concluded that when one party is given discretion under a contract, that discretion must be exercised in good faith.[34] Noting that the

23. *Id*. at *44.
24. *Id*.
25. *Id*. at *47.
26. *Id*.
27. *Id*. at *47–49. The court noted, for example, that various materials communicated that debit card point of sale transactions were deducted "immediately" or "automatically" from the consumer's account. *Id*. at *49.
28. *Id*. at *51–52.
29. *Id*. at *52 (citing 12 C.F.R. § 7.4002).
30. *Id*. at *52–53.
31. These complaints have been consolidated into multi-district litigation. *See In re* Checking Account Overdraft Litig., 694 F. Supp. 2d 1302 (S.D. Fla. 2010).
32. *Id*. at 1329.
33. *Id*. at 1317.
34. *Id*. at 1314–15.

permissibility of HTL posting for check transactions under the Uniform Commercial Code does not apply to debit card transactions,[35] the court determined that the plaintiffs had sufficiently alleged a lack of good faith by the banks.[36]

- Unconscionability. The court found that the plaintiffs adequately pled both (i) procedural unconscionability, due to the disparity in sophistication and bargaining power between the plaintiffs and the banks and the voluminous "boilerplate" language in the account agreement,[37] and (ii) substantive unconscionability, due to account agreements that permitted the defendants to reorder transactions in a way to maximize overdraft fees, fees which bore no reasonable relationship to the costs or risks of such service.[38]

In addition, the court refused to dismiss claims on the grounds of unjust enrichment, conversion, and a variety of state unfair and deceptive acts and practices statutes.[39] The court rejected the defendants' preemption defense, finding that the plaintiffs were not challenging the banks' right to charge overdraft fees,[40] but rather the banks' practice of manipulating the transactions, which raised state contract and tort claims.[41]

Deposit Insurance Developments

Transaction Account Guarantee Program

On April 13, 2010, the FDIC published an Interim Final Rule that extended and amended its Transaction Account Guarantee Program ("TAG Program").[42] Under the TAG Program, balances in noninterest-bearing transaction accounts, interest on lawyers trust accounts ("IOLTAs"), and negotiable order of withdrawal ("NOW") accounts with low interest rates are fully insured, without regard to the FDIC's Standard Maximum Deposit Insurance Amount ("SMDIA").[43] The Interim Final Rule, which became effective on April 19, 2010,[44] made several changes to the TAG Program, including the following:

35. *Id*. at 1316.

36. *Id*. at 1317. The court did dismiss the claim of breach of the implied covenant based on Texas law, due to a higher bar required for such claims. *Id*.

37. *Id*. at 1319–20. The court also noted that the plaintiffs alleged that they were not notified they had the option to decline the overdraft protection service, when they did in fact have the option. *Id*.

38. *Id*.

39. *Id*. at 1321–23.

40. *Id*. at 1311.

41. *Id*. at 1313.

42. Fed. Deposit Ins. Corp., Transaction Account Guarantee Extension Interim Final Rule (Apr. 13, 2010) (FIL-15-2010), *available at* http://www.fdic.gov/news/news/financial/2010/fil10015.html.

43. *See* 12 C.F.R. pt. 370 (2010).

44. Amendment of the Temporary Liquidity Guarantee Program to Extend the Transaction Account Guarantee Program with Opportunity to Opt Out, 75 Fed. Reg. 20257 (Apr. 19, 2010) (to be codified at 12 C.F.R. pt. 370).

- the TAG Program was extended from June 30, 2010, to December 31, 2010;[45] and
- effective July 1, 2010, the interest rate that may be paid on NOW accounts to qualify for inclusion in the TAG Program was reduced (from 0.50 percent to 0.25 percent).[46]

Dodd-Frank Act Changes to Deposit Insurance Coverage

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[47] permanently increased the SMDIA to $250,000.[48] In addition, effective December 31, 2010, the Dodd-Frank Act fully insured noninterest-bearing transaction accounts.[49] This deposit insurance coverage of all noninterest-bearing transaction accounts differs from coverage of such accounts under the TAG Program in two key respects: First, the Dodd-Frank Act's definition of the term "noninterest-bearing transaction account" does not include (i) IOLTAs or (ii) NOW accounts with interest rates of 0.25 percent or less.[50] Second, institutions have no ability to opt out of the new additional insurance coverage amount for noninterest-bearing transaction accounts. As a result, all institutions pay deposit insurance assessments on covered noninterest-bearing transaction accounts.[51]

Debit Card Interchange and Payment Card Network Rules

"Reasonable and Proportional" Interchange Fees

Included within the Dodd-Frank Act is a heavily publicized amendment to the Electronic Fund Transfer Act ("EFTA Amendment") that limits debit card transaction interchange fees and establishes certain new payment card network practices.[52] At the center of the EFTA Amendment are provisions that require that the amount of interchange transaction fees received or charged by an issuer in con-

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45. 12 C.F.R. § 370.2(o) (2010) (as added by the Interim Final Rule).

46. 12 C.F.R. § 370.2(h)(3), (4) (2010) (as revised by the Interim Final Rule).

47. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

48. *Id.* § 335(a), 124 Stat. at 1540 (to be codified at 12 U.S.C. § 1821(a)(1)(E)). A corresponding change was also made to the amount of share insurance available under the Federal Credit Union Act. *Id.* § 335(b), 124 Stat. at 1540 (to be codified at 12 U.S.C. § 1787(k)(5)). The increase was retroactive to January 1, 2008. *See* § 335(a), (b), 124 Stat. at 1540 (to be codified at 12 U.S.C. §§ 1821(a)(1)(E), 1787(k)(5)). As a result, the increased SMDIA applied to six bank failures that occurred between January 1, 2008, and October 3, 2008. *See* Fed. Deposit Ins. Corp., Standard Deposit Insurance Coverage Amount of $250,000 Made Permanent (July 21, 2010) (FIL-40-2010), *available at* http://www.fdic.gov/news/news/financial/2010/fil10040.html.

49. Dodd-Frank Act, *supra* note 47, § 343(a)(1), 124 Stat. at 1544 (to be codified at 12 U.S.C. § 1821(a)(1)(B)(ii)). This date is the extended sunset date for the FDIC's TAG Program, as discussed above. This full coverage is subject to a prospective repeal date of January 1, 2013. *Id.* § 343(a)(3), 124 Stat. at 1544–45 (to be codified at 12 U.S.C. § 1821(a)(1)(B)).

50. *Id.* § 343(a)(1)(A)(ii), 124 Stat. at 1544 (to be codified at 12 U.S.C. § 1821(a)(1)(B)(iii)).

51. *Id.* § 343(a), 124 Stat. at 1544 (to be codified at 12 U.S.C. § 1821(a)(1)(B)).

52. *Id.* § 1075(a), 124 Stat. at 2068–74 (to be codified at 15 U.S.C. § 1693o-2) (adding EFTA § 920).

nection with an "electronic debit transaction"[53] be "reasonable and proportional" to the cost incurred by the issuer for such transaction.[54] The EFTA Amendment directs the FRB to issue regulations establishing standards for assessing whether a debit interchange transaction fee is reasonable and proportional.[55] When establishing regulations, the FRB must (i) consider the "functional similarity" between electronic debit transactions and check transactions that clear at par; and (ii) distinguish between (a) incremental costs incurred by an issuer for its role in the authorization, clearance, or settlement of a particular transaction—costs which should be considered, and (b) other costs incurred by an issuer that are not specific to a particular transaction, which should not be considered.[56] The FRB, however, may allow for an adjustment for fraud-related costs if: (i) such adjustment is reasonably necessary to make allowance for costs incurred by the issuer in preventing fraud; and (ii) the issuer complies with fraud-related standards to be established by the FRB.[57] The reasonable and proportional debit interchange fee limitation does not apply to any issuer that, together with its affiliates, holds assets of less than $10 billion[58] or to transactions initiated using a debit card or general-use prepaid card offered under a government-administered payment program or a general-use reloadable prepaid card.[59]

53. "Electronic debit transaction" means "a transaction in which a person uses a debit card." *Id.*, 124 Stat. at 2073 (to be codified at 15 U.S.C. § 1693o-2(c)(5)) (adding EFTA § 920(c)(5)). A "debit card" "(A) means any card, or other payment code or device, issued or approved for use through a payment card network to debit an asset account (regardless of the purpose for which the account is established), whether authorization is based on signature, PIN, or other means; (B) includes a general-use prepaid card, as that term is defined in section 915(a)(2)(A); and (C) does not include paper checks." *Id.*, 124 Stat. at 2073 (to be codified at 15 U.S.C. § 1693o-2(c)(2)) (adding EFTA § 920(c)(2)).

54. *Id.*, 124 Stat. at 2068 (to be codified at 15 U.S.C. § 1693o-2(a)(2)) (adding EFTA § 920(a)(2)). The fee limitation provisions are effective at the end of the twelve-month period beginning on the date of the enactment of the Act, or July 21, 2011. *Id.*, 124 Stat. at 2072 (to be codified at 15 U.S.C. § 1693o-2(a)(9)) (adding EFTA § 920(a)(9)).

55. *Id.*, 124 Stat. at 2068 (to be codified at 15 U.S.C. § 1693o-2(a)(3)(A)) (adding EFTA § 920(a)(3)(A)). These regulations must be issued no later than nine months after the date of enactment of the Dodd-Frank Act. *Id.*

56. *Id.*, 124 Stat. at 2068–69 (to be codified at 15 U.S.C. § 1693o-2(a)(4)) (adding EFTA § 920(a)(4)).

57. *Id.*, 124 Stat. at 2069 (to be codified at 15 U.S.C. § 1693o-2(a)(5)(A)) (adding EFTA § 920(a)(5)(A)). Like the "reasonable and proportional" baseline rules, the FRB must promulgate rules establishing standards for making fraud-related adjustments by nine months after the date of enactment of the Dodd-Frank Act. *Id.*, 124 Stat. at 2069 (to be codified at 15 U.S.C. § 1693o-2(a)(5)(B)(i)) (adding EFTA § 920(a)(5)(B)(i)). The FRB is directed to consider a variety of factors in making its determination. *See id.* (to be codified at 15 U.S.C. § 1693r(a)(5)(B)(ii)) (adding EFTA § 920(a)(5)(B)(ii)). Within this same time period, the FRB must also promulgate rules to ensure that a network fee is not used to compensate an issuer directly or indirectly or to circumvent or evade the reasonable and proportional fee restrictions. *Id.*, 124 Stat. at 2071 (to be codified at 15 U.S.C. § 1693o-2(a)(8)(B)) (adding EFTA § 920(a)(8)(B)).

58. *Id.*, 124 Stat. at 2070 (to be codified at 15 U.S.C. § 1693o-2(a)(6)) (adding EFTA § 920(a)(6)).

59. *Id.*, 124 Stat. at 2070–71 (to be codified at 15 U.S.C. § 1693o-2(a)(7)(A)) (adding EFTA § 920(a)(7)(A)). Note, however, that after one year after the effective date of the amendment and its implementing rules, the "reasonable and proportional" limitation will apply to cards where an overdraft fee or fee for the first ATM withdrawal per month is imposed. *Id.*, 124 Stat. at 2071 (to be codified at 15 U.S.C. § 1693o-2(a)(7)(B)) (adding EFTA § 920(a)(7)(B)).

Payment Card Network Exclusivity

In addition to limiting debit card interchange fees, the EFTA Amendment also directs the FRB to prescribe regulations prohibiting an issuer or payment card network from restricting the number of payment card networks on which an electronic debit transaction may be processed to one network or two or more affiliated networks.[60] The FRB must also draft regulations prohibiting an issuer or payment card network from inhibiting merchants accepting debit cards for payment from directing the routing of electronic debit transactions over any payment card network that processes such transactions.[61]

Payment Card Network Anti-Discrimination Provisions

The EFTA Amendment prohibits a payment card network from directly or indirectly:

- inhibiting the ability of any person to provide a discount or in-kind incentive for payment by the use of cash, checks, debit cards, or credit cards, as long as the discount or in-kind incentive does not differentiate on the basis of the issuer or the payment card network and any discount or incentive is offered to all prospective buyers and disclosed clearly and conspicuously;[62]
- inhibiting the ability of any person to set a minimum dollar value for the acceptance by that person of credit cards (note that debit cards are not included) as long as the minimum dollar amount does not differentiate between issuers or payment card networks and does not exceed $10;[63] or
- inhibiting the ability of any federal agency or institution of higher education to set a maximum dollar value for the acceptance of credit cards, as long as the maximum dollar amount does not differentiate between issuers or payment card networks.[64]

Interest on Demand Deposits

Currently, the Federal Reserve Act, the Home Owners Loan Act, and the Federal Deposit Insurance Act all prohibit the payment of interest on demand deposit

60. *Id.*, 124 Stat. at 2072 (to be codified at 15 U.S.C. § 1693o-2(b)(1)(A)) (adding EFTA § 920(b)(1)(A)). The FRB must prescribe the regulations by one year after the enactment date of the Act. *Id.*

61. *Id.* (to be codified at 15 U.S.C. § 1693o-2(b)(1)(B)) (adding EFTA § 920(b)(1)(B)). The FRB must prescribe the regulations by one year after the enactment date of the Dodd-Frank Act. *Id.*

62. *Id.* (to be codified at 15 U.S.C. § 1693o-2(b)(2)(A)) (adding EFTA § 920(b)(2)(A)).

63. *Id.*, 124 Stat. at 2073 (to be codified at 15 U.S.C. § 1693o-2(b)(3)(A)(i)) (adding EFTA § 920(b)(3)(A)(i)).

64. *Id.* (to be codified at 15 U.S.C. § 1693r(b)(3)(A)(ii)) (adding EFTA § 920(b)(3)(A)(ii)). Note that the minimum dollar threshold of $10 may be increased by regulations of the FRB. *Id.* (to be codified at 15 U.S.C. § 1693o-2(b)(3)(B)) (adding EFTA § 920(b)(3)(B)).

accounts.[65] Effective July 21, 2011, the Dodd-Frank Act repeals these existing prohibitions.[66]

Expedited Funds Availability Act/Regulation CC

Consolidation of Check Processing Regions

On December 31, 2009, the FRB issued a Final Rule amending its Regulation CC.[67] The Final Rule, published in the *Federal Register* on January 5, 2010,[68] reassigned the routing symbols listed for the Federal Reserve Bank of Atlanta to the Federal Reserve Bank of Cleveland.[69] When this Final Rule became effective on February 27, 2010, there was only a single check processing region for the entire country.[70] As a result, there are no longer any distinctions in the processing and funds availability of "local" and "nonlocal" checks.[71]

Dodd-Frank Act Changes to Funds Availability

The Expedited Funds Availability Act and FRB Regulation CC currently require financial institutions to make up to $100 of deposited checks available to the depositor no later than the business day after the deposit.[72] The Dodd-Frank Act increases the minimum amount subject to this special rule to $200,[73] and provides for future adjustments every five years based on inflation.[74] The change will become effective on July 21, 2011.[75]

Gift Card Rules

The Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "Credit CARD Act")[76] amended the EFTA to restrict the imposition of dormancy, inactivity, or service fees in connection with gift certificates, store gift cards, and general-use prepaid cards and to require that such products have an expiration

65. *See* 12 U.S.C. § 371a (2006); *id.* § 1464(b)(1)(B); 12 U.S.C.A. § 1828(g) (West 2009).

66. Dodd-Frank Act, *supra* note 47, § 627, 124 Stat. at 1640 (to be codified at 12 U.S.C. §§ 371a(i), 1464(b)(1)(B) & 1828(g)).

67. 12 C.F.R. pt. 229 (2010).

68. Availability of Funds and Collection of Checks, 75 Fed. Reg. 219 (Jan. 5, 2010) (to be codified at 12 C.F.R. pt. 229).

69. *See id.* at 219–20.

70. *See id.* at 219.

71. *See id.*

72. *See* 12 U.S.C. § 4002(a)(2)(D), (b)(3)(C) & (c)(1)(B)(iii) (2006).

73. Dodd-Frank Act, *supra* note 47, § 1086(e), 124 Stat. at 2086 (to be codified at 12 U.S.C. § 4002(a)(2)(D), (b)(3)(C) & (c)(1)(B)(iii)).

74. *Id.* § 1086(f), 124 Stat. at 2086 (to be codified at 12 U.S.C. § 4006(f)).

75. *Id.* § 1062, 124 Stat. at 2039–40 (to be codified at 12 U.S.C. § 5582). Pursuant to section 1062 of the Dodd-Frank Act, these changes become effective on the "transfer date" as defined in section 311 of the Dodd-Frank Act. *Id.* § 311, 124 Stat. at 1520–21 (to be codified at 12 U.S.C. § 5411). In accordance with section 311(b)(2), the Secretary of the Treasury designated July 21, 2011, as the transfer date. Bureau of Consumer Financial Protection, 75 Fed. Reg. 57252, 57252 (Sept. 20, 2010).

76. Credit Card Accountability Responsibility and Disclosure Act of 2009, Pub. L. No. 111-24, § 401, 123 Stat. 1734, 1751 (2009) (to be codified at 15 U.S.C. § 1601).

date that is at least five years from the date of issuance for a gift certificate or the date when funds were last loaded to a store gift card or general-use prepaid card.[77] Most of these requirements became effective August 22, 2010; however, the Credit CARD Act was subsequently amended to delay the effective date of some of the new requirements for certificates or cards produced before April 1, 2010 (the "Gift Card Amendment"), in order to permit the sale of existing card stock through January 31, 2011.[78]

The FRB adopted a final rule implementing the Credit CARD Act's requirements by amending Regulation E and its Commentary, effective August 22, 2010 (the "Gift Card Rule").[79] The FRB subsequently adopted an interim final rule further amending the Regulation E Commentary, effective August 22, 2010, to implement the Gift Card Amendment's delayed effective date for existing card stock.[80]

The Gift Card Rule generally applies to three types of consumer purpose prepaid products: (i) gift certificates, (ii) store gift cards, and (iii) general-use prepaid cards.[81] It permits assessment of a dormancy, inactivity, or service fee in connection with a gift certificate, store gift card, or general-use prepaid card only when there has been no card or certificate activity for the one-year period before the fee is imposed; only one fee is assessed during a calendar month; and the card reflects the amount of the fee that may be charged, the frequency with which it may be assessed, and that the fee may be assessed for inactivity.[82]

In addition, the type and amount of any other fee that may be imposed (or calculation formula), as well as the conditions under which it may be imposed, must be disclosed on or with the certificate or card.[83] The card or certificate must also reflect a toll-free telephone number and, if one is maintained, a website that a consumer may use to obtain information about these additional fees.[84]

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77. EFTA § 915(c)(2), 15 U.S.C. § 1693*l*-1 (Supp. III 2009).

78. Credit Card Accountability Responsibility and Disclosure Act—Amendment, Pub. L. No. 111-209, § 1, 124 Stat. 2254, 2254 (July 27, 2010).

79. Electronic Fund Transfers, 75 Fed. Reg. 16580 (Apr. 1, 2010) (to be codified at 12 C.F.R. pt. 205).

80. Electronic Fund Transfers Rule, 75 Fed. Reg. 50683 (Aug. 17, 2010) (to be codified at 12 C.F.R. pt. 205). The FRB accepted public comments regarding the interim rule until September 16, 2010. *Id.* at 50683.

81. Electronic Fund Transfers, 75 Fed. Reg. at 16614 (to be codified at 12 C.F.R. § 205.20). A "gift certificate" is a nonreloadable consumer purpose prepaid card or certificate that is issued in a specific amount for use at a single merchant or an affiliated group of merchants to purchase goods or services. *Id.* (to be codified at 12 C.F.R. § 205.20(a)(1)). A "store gift card" is a consumer purpose prepaid card or certificate that is issued in a specified amount, whether or not that amount may be increased or reloaded, which may be used at a single merchant or an affiliated group of merchants to purchase goods or services. *Id.* (to be codified at 12 C.F.R. § 205.20(a)(2)). A "general-use prepaid card" is a consumer purpose prepaid card, code, or device, which may or may not be reloadable, that is issued in a specified amount and may be redeemed for goods or services at multiple, unaffiliated merchants or used at ATMs. *Id.* (to be codified at 12 C.F.R. § 205.20(a)(3)). The Gift Card Rule does not apply to cards, codes, or other devices when the end use is for business purposes, such as to pay for travel expenses or office supplies. *Id.*

82. *Id.* at 16614–15 (to be codified at 12 C.F.R. § 205.20(d)).

83. *Id.* at 16615 (to be codified at 12 C.F.R. § 205.20(f)(1)).

84. *Id.* (to be codified at 12 C.F.R. § 205.20(f)(2)).

A gift certificate, store gift card, or general-use prepaid card may only be sold or issued if the expiration date of the underlying funds is at least five years after the date of issuance or the last date when funds were loaded.[85] The card or certificate must also reflect the expiration date for the underlying funds, along with a toll-free phone number and, if one is maintained, a website that a consumer may use to obtain a replacement card or certificate after the card or certificate expires if the underlying funds may be available.[86] No fee may be imposed for replacing an expired card or certificate, or for providing the consumer with the remaining balance (for example, by check) if the underlying funds remain valid.[87]

For any gift certificate, store gift card, or general-use prepaid card produced before April 1, 2010, the effective date of these disclosure requirements, as well as the requirement for an expiration date of not less than five years, has been delayed until January 31, 2011, provided that the card issuer meets certain conditions.[88] Certificates or cards produced before April 1, 2010, that do not fully comply with Regulation E's gift card requirements may not be sold on or after January 31, 2011.[89]

Conclusion

Changes in federal legislation and regulation of deposits and payment systems continue to occur at a rapid pace. These changes, combined with litigation developments, have been challenging for financial institutions, consumers, and lawyers. Given current economic and financial conditions and related major developments in the regulation of financial institutions (such as those imposed under the Dodd-Frank Act), the pace of change (and therefore the challenges) for deposit transactions and payment systems may continue unabated for the foreseeable future.

85. *Id.* (to be codified at 12 C.F.R. § 205.20(e)).
86. *Id.* (to be codified at 12 C.F.R. § 205.20(e)(3)(ii)).
87. *Id.* (to be codified at 12 C.F.R. § 205.20(e)(4)).
88. Electronic Fund Transfers Rule, 75 Fed. Reg. 50683, 50684 (Aug. 17, 2010) (to be codified at 12 C.F.R. pt. 205).
89. *Id.*

The Dodd-Frank Act's New Federalism

*By Ralph T. Wutscher and David L. Beam**

Introduction

For decades, Congress has played at most a peripheral role in defining the extent to which the National Bank Act ("NBA")[1] and Home Owners' Loan Act ("HOLA")[2] preempt state laws for national banks and federal savings associations, respectively. The preemption rules that have evolved under these two federal statutes have been developed almost entirely by courts and the two primary regulators of federally chartered depository institutions—the Office of the Comptroller of the Currency ("OCC") for national banks, and the Office of Thrift Supervision ("OTS") for federal savings associations.

However, in 2010 Congress reasserted its authority with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] Sections 1044 to 1048 of the Dodd-Frank Act amend the NBA and HOLA to "clarify" the circumstances under which these two laws will preempt state laws, and for which types of institutions and their subsidiaries.[4] Among other things, these "clarifying" amendments, which as of this writing are scheduled to take effect on July 21, 2011,[5] overturn what was arguably the most important Supreme Court decision on preemption for federally chartered banks over the last decade, as well as a host of preemption determinations by the OCC and OTS.[6]

This survey describes the provisions of the Dodd-Frank Act that amend the NBA and HOLA to clarify the scope of preemption by these two federal laws,[7] fol-

* Ralph T. Wutscher is the Chair, and David L. Beam the Vice Chair, of the Preemption and Federalism Subcommittee of the Consumer Financial Services Committee of the American Bar Association Section of Business Law. Mr. Wutscher is a principal with Kahrl Wutscher LLP in Chicago, Illinois. Mr. Beam is a partner with K&L Gates LLP in Washington, D.C. This survey represents the views of the authors and not the firms with which they are associated.

1. Act of June 3, 1864, ch. 106, 13 Stat. 99 (codified as amended in scattered sections of 12 U.S.C.).
2. Act of June 13, 1933, ch. 64, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461–1470 (2006)).
3. Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].
4. *See id.* §§ 1044–1048, 124 Stat. at 2014–18 (to be codified at 12 U.S.C. §§ 25b, 1465 & 5551 note); *see also infra* notes 9–61 and accompanying text.
5. Designated Transfer Date, 75 Fed. Reg. 57252, 57253 (Sept. 20, 2010).
6. *See infra* notes 42–53 and accompanying text.
7. *See infra* notes 9–61 and accompanying text.

lowed by discussion of case law developments concerning the preemptive effect of federal financial laws other than the NBA and HOLA.[8]

Legislative Developments: The Dodd-Frank Act Amends the NBA and HOLA

Preemption Standards for National Banks

Section 1044 of the Dodd-Frank Act added a new section to the NBA entitled "Preemption Standards for National Banks and Subsidiaries Clarified."[9] The Office of Law Revision Counsel has designated this new section for codification in the United States Code at 12 U.S.C. § 25b, so for ease of reference it is referred to here as "§ 25b."

As noted immediately below, § 25b addresses the standards that will govern whether and to what extent the NBA preempts a state law after the designated transfer date. Section 25b also establishes procedures that the OCC must follow when issuing a preemption determination for certain types of state laws.[10]

Substantive Preemption Standards

State Consumer Financial Laws

Definition of SCFL. Section 25b identifies a class of state laws that it labels state consumer financial laws ("SCFLs").[11] An SCFL is any state law "that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto, with respect to a consumer."[12]

Overview of the Preemption Standard for SCFLs. An SCFL will be preempted for a national bank only if:

- "application of [the SCFL] would have a discriminatory effect on national banks, in comparison with the effect of the [SCFL] on a bank chartered by the state";[13]
- "in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States" in *Barnett Bank of Marion County,*

8. *See infra* notes 63–85 and accompanying text.
9. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2014–17 (to be codified at 12 U.S.C. § 25b).
10. These procedural provisions are described in *infra* notes 27–41 and accompanying text.
11. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2014–15 (to be codified at 12 U.S.C. § 25b(a)(2)).
12. *Id.*
13. *Id.*, 124 Stat. at 2015 (to be codified at 12 U.S.C. § 25b(b)(1)(A)).

N.A. v. Nelson,[14] "the State consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers";[15] or

- a law other than the NBA preempts the state law.[16]

Interest Exportation Provisions

Overview of Interest Exportation. Section 30 of the NBA (which is better known as § 85 because it is codified at 12 U.S.C. § 85) provides that a national bank may "take, receive, reserve, and charge on any loan or discount made . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located."[17] Section 85 preempts any state interest restrictions that might have applied to the transaction in the absence of § 85, including restrictions under the laws of the borrower's state (if different from the bank's state).[18]

The OCC rules implementing § 85 define "interest" broadly to include "any payment compensating a creditor or prospective creditor for an extension of credit, making available of a line of credit, or any default or breach by a borrower of a condition upon which credit was extended."[19] The OCC regulation goes on to provide that this definition of interest includes the following:

- numerical periodic rates;
- late fees;
- creditor-imposed not sufficient funds (NSF) fees charged when a borrower tenders payment on a debt with a check drawn on insufficient funds;
- overlimit fees;
- annual fees;
- cash advance fees; and
- membership fees.[20]

Dodd-Frank Act Provisions on Interest Exportation. Subsection 25b(f) provides that no provision of the NBA "shall be construed as altering or otherwise affecting the authority conferred by [§ 85] for the charging of interest by a national bank at the rate allowed by the laws of the State, territory, or district where the bank is located, including with respect to the meaning of 'interest' under such provisions."[21]

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14. 517 U.S. 25 (1996).
15. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2015 (to be codified at 12 U.S.C. § 25b(b)(1)(B)).
16. *Id*. (to be codified at 12 U.S.C. § 25b(b)(1)(C)).
17. 12 U.S.C. § 85 (2006). Section 85 alternatively allows national banks to charge interest at up to "1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located." *Id*.
18. Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 316–19 (1978).
19. 12 C.F.R. § 7.4001(a) (2010).
20. *Id*.
21. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2017 (to be codified at 12 U.S.C. § 25b(f)).

Other Laws

Section 25b does not expressly address what the preemption standard is for laws that are neither covered by § 85 nor SCFLs. Presumably, the OCC's current preemption rules would continue to apply with respect to these other laws to the same extent that the OCC's preemption rules do today, assuming of course that the OCC does not repeal or amend them in the process described below or otherwise.

The Process for Determining that the NBA Preempts an SCFL

Procedures for Preemption Determinations Based on the *Barnett* Decision

As noted above,[22] an SCFL will be preempted for a national bank in any of three situations: (i) where the SCFL has a discriminatory effect on national banks vis-à-vis their counterparts chartered by the state that enacted the SCFL;[23] (ii) where, "in accordance with the legal standard for preemption in" *Barnett Bank of Marion County, N.A. v. Nelson*,[24] the SCFL "prevents or significantly interferes with" the exercise of a national bank's powers;[25] or (iii) where a federal law besides the NBA preempts the SCFL.[26] Section 25b provides special procedures that the OCC must follow to determine that an SCFL is preempted under the second prong (i.e., to determine that an SCFL prevents or significantly interferes with a national bank's ability to exercise its powers).

Section 25b(b)(1)(B) says that the OCC may determine that an SCFL is preempted under the second prong on a "case-by-case basis."[27] Section 25b(b)(3)(A) defines "case-by-case" basis as "a determination pursuant to [§ 25b] made by the [OCC] concerning the impact of a particular State consumer financial law on any national bank that is subject to that law, or the law of any other State with substantively equivalent terms."[28] When making a determination that an SCFL has "substantively equivalent terms" to an SCFL that is the subject of a case-by-case preemption determination, the OCC must consult with the Bureau of Consumer Financial Protection ("CFPB") and take the CFPB's views into account when making the determination.[29]

Subsection 25b(c) also provides that no "regulation or order" of the OCC prescribed under § 25b(b)(1)(B) "shall be interpreted or applied so as to invalidate,

22. *See supra* notes 13–16 and accompanying text.
23. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2015 (to be codified at 12 U.S.C. § 25b(b)(1)(A)).
24. 517 U.S. 25 (1996).
25. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2015 (to be codified at 12 U.S.C. § 25b(b)(1)(B)).
26. *Id.* (to be codified at 12 U.S.C. § 25b(b)(1)(C)).
27. *Id.* (to be codified at 12 U.S.C. § 25b(b)(1)(B)).
28. *Id.* (to be codified at 12 U.S.C. § 25b(b)(3)(A)).
29. *Id.* (to be codified at 12 U.S.C. § 25b(b)(3)(B)).

or otherwise declare inapplicable to a national bank, the provision of the State consumer financial law, unless substantial evidence, made on the record of the proceeding, supports the specific finding regarding the preemption of such provision in accordance with the legal standard of the decision" in *Barnett*.[30]

Section 25b(b)(6) provides that a determination by the OCC that a state law is preempted because it prevents or significantly interferes with a national bank's ability to exercise its powers must "be made by the [OCC], and shall not be delegable to another officer or employee of the [OCC]."[31]

Preemption Determinations for SCFLs Not Based on *Barnett*

The requirement that the OCC make preemption determinations on a case-by-case basis[32] and the requirements that preemption determinations be based on "substantial evidence, made on the record of the proceeding"[33] both apply, by their terms, only to determinations that an SCFL prevents or significantly interferes with a national bank's ability to exercise its powers. Thus, it does not appear that the OCC must comply with these procedural restrictions when making a determination that an SCFL has a discriminatory effect on a national bank.[34] Whether the OCC has the authority to issue a determination that an SCFL is preempted by some federal law besides the NBA,[35] and the procedures that the OCC must follow to do so, may depend on the provisions of that other law.

Periodic Review of Preemption Determinations

Section 25b(d) requires the OCC to periodically review its preemption determinations and make reports to Congress.[36] Section 25b(d)(1) provides that the OCC must "periodically conduct a review, through notice and public comment, of each determination that a provision of Federal law preempts a State consumer financial law."[37] This review must occur no less frequently than every five years for each preemption determination.[38]

After the OCC reviews the comments submitted during the review process, the OCC must "publish a notice in the *Federal Register* announcing the decision to continue or rescind the determination or a proposal to amend the determination."[39] The OCC must also submit a report in connection with each review of a preemption determination to the House Financial Services Committee and the Senate

30. *Id.*, 124 Stat. at 2016 (to be codified at 12 U.S.C. § 25b(c)).
31. *Id.* (to be codified at 12 U.S.C. § 25b(b)(6)).
32. *Id.*, 124 Stat. at 2015 (to be codified at 12 U.S.C. § 25b(b)(1)(B)).
33. *Id.* (to be codified at 12 U.S.C. § 25b(c)).
34. *See id.* (to be codified at 12 U.S.C. § 25b(b)(1)(A)).
35. *See id.* (to be codified at 12 U.S.C. § 25b(b)(1)(C)).
36. *Id.*, 124 Stat. at 2016 (to be codified at 12 U.S.C. § 25b(d)).
37. *Id.* (to be codified at 12 U.S.C. § 25b(d)(1)).
38. *Id.*
39. *Id.*

Committee on Banking, Housing, and Urban Affairs.[40] This report must "address whether the agency intends to continue, rescind, or propose to amend any determination that a provision of Federal law preempts a State consumer financial law, and the reasons therefor."[41]

Preemption for Parties Associated with National Banks

Preemption under the NBA is not limited to national banks. In the 2007 decision in *Watters v. Wachovia Bank, N.A.*,[42] the United States Supreme Court explained:

> We have never held that the preemptive reach of the NBA extends only to a national bank itself. Rather, in analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank's powers, not on its corporate structure.[43]

The Supreme Court applied this principle in *Watters* to conclude that state regulatory approval requirements were preempted for operating subsidiaries of national banks, which the Court characterized as vehicles through which national banks exercise their powers.[44] Lower courts have invoked the *Watters* passage quoted above to conclude that the NBA also preempted state laws for agents of national banks in some situations.[45]

The Dodd-Frank Act adds three separate provisions to the NBA that overturn the holding in *Watters:* The first is § 25b(b)(2), which provides that the NBA and section 24 of the Federal Reserve Act[46] "do not preempt, annul, or affect the applicability of any State law to any subsidiary or affiliate of a national bank (other than a subsidiary or affiliate that is chartered as a national bank)";[47] sec-

40. *Id*. (to be codified at 12 U.S.C. § 25b(d)(2)).
41. *Id*.
42. 550 U.S. 1 (2007).
43. *Id*. at 18 (citing Barnett Bank of Marion Cnty., N.A. v. Nelson, 517 U.S. 25, 32 (1996)).
44. *Id*. at 18–20.
45. *See, e.g.*, Pac. Capital Bank, N.A. v. Blumenthal, 542 F.3d 341, 353 (2d Cir. 2008) ("If a state statute subjects non-bank entities to punishment for acting as agents for national banks with respect to a particular NBA-authorized activity and thereby significantly interferes with national banks' ability to carry on that activity, the state statute does not escape preemption on the theory that, on its face, it regulates only non-bank entities."); State Farm Bank, N.A. v. Reardon, 539 F.3d 336 (6th Cir. 2008) (federal banking laws preempt any state laws that hinder a federal thrift's lending authority, even if the state laws purport to apply to a party other than the thrift); SPGGC, LLC v. Ayotte, 488 F.3d 525, 533 (1st Cir. 2007) ("It would be contrary to the language and intent of the National Bank Act to allow states to avoid preemption simply by enacting laws that prohibited non-bank firms from providing national banks with the resources to carry out their banking activities."); SPGGC, LLC v. Blumenthal, 505 F.3d 183, 190 (2d Cir. 2007) (stating that preemption analysis under federal banking laws should focus "less on the identity of the plaintiff . . . than on whether and to what extent the [gift card being sold by the bank's agent in the case] represented an exercise of" the bank's powers under federal law).
46. 12 U.S.C. § 371 (2006).
47. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2015 (to be codified at 12 U.S.C. § 25b(b)(2)).

ond, Congress repeated this basic point—and extends it to agents of national banks—in § 25b(h), which provides that no provision of the NBA or section 24 of the Federal Reserve Act will "preemp[t], annu[l], or affect[t] the applicability of State law to any subsidiary, affiliate, or agent of a national bank (other than a subsidiary, affiliate, or agent that is chartered as a national bank)";[48] and finally, § 25b(e) provides that, "[n]otwithstanding any provision of" the NBA or section 24 of the Federal Reserve Act, "a State consumer financial law shall apply to a subsidiary or affiliate of a national bank (other than a subsidiary or affiliate that is chartered as a national bank) to the same extent that the State consumer financial law applies to any person, corporation, or other entity subject to such State law."[49]

Each of these provisions overturns the holding in *Watters*—that states cannot regulate the powers that a national bank exercises through an operating subsidiary any more than states can regulate such powers that a national bank exercises directly—as well as the lower court decisions extending the *Watters* holding to agents.[50] But § 25b(e) suggests that the NBA might still preempt some state laws that discriminate against subsidiaries or affiliates of national banks.[51] Unlike the other two provisions dedicated to overturning *Watters*, § 25b(e) does not simply provide that the NBA will not "preempt, annul, or affect" any state laws for subsidiaries and affiliates of national banks; rather, § 25b(e) provides that the SCFL will apply to subsidiaries and affiliates of national banks "to the same extent" that the SCFL "applies to any person, corporation, or other entity subject to" the SCFL.[52] Courts might interpret § 25b(e) to preempt SCFLs that impose special restrictions or requirements on a subsidiary or affiliate of a national bank specifically because it is owned or affiliated with a national bank.

Further, because § 25b(e) applies "[n]otwithstanding any provision of" the NBA, it would appear to take precedence over § 25b(b)(2) and § 25b(h), to the extent there is any inconsistency between § 25b(e) and one of the other two provisions dealing with subsidiaries and affiliates.[53]

Preemption Standards for Federal Thrifts

Section 1046 of the Dodd-Frank Act adds a new section 6 to HOLA.[54] This new section 6 addresses the extent to which HOLA preempts state laws for federal savings associations.

48. *Id.* § 1045, 124 Stat. at 2017 (to be codified at 12 U.S.C. § 25b(h)(2)).
49. *Id.* § 1044(a), 124 Stat. at 2016–17 (to be codified at 12 U.S.C. § 25b(e)).
50. *See* Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007); *supra* notes 42–49 and accompanying text.
51. *See supra* note 49 and accompanying text.
52. *See id.*
53. Dodd-Frank Act, *supra* note 3, § 1044(a), 124 Stat. at 2016–17 (to be codified at 12 U.S.C. § 25b(e)).
54. *Id.* § 1046(a), 124 Stat. at 2017 (to be codified at 12 U.S.C. § 1465).

End of Field Preemption

In 1972, the U.S. Supreme Court held that the rulemaking provisions in HOLA gave the Federal Home Loan Bank Board ("FHLBB"), which was at the time the primary regulator of federal savings associations, the authority to issue regulations that preempted state laws for federal savings associations.[55] The OTS—which assumed the FHLBB's supervisory responsibilities and rulemaking powers in 1992—used this power to issue regulations expressly declaring that HOLA and the OTS regulations implementing HOLA "occupied the field" of various activities of federal thrifts, including lending,[56] deposit-taking,[57] and fiduciary activities.[58] However, section 6(b) of HOLA, as added by the Dodd-Frank Act, provides that HOLA "does not occupy the field in any area of State law."[59]

Preemption Parity with National Banks

Subsection 6(a) of HOLA, as added by the Dodd-Frank Act, provides that:

> [A]ny determination by a court or by the Director [of the OTS] or any successor officer or agency regarding the relation of a State law to a provision of this Act or any regulation or order prescribed under this Act shall be made in accordance with the laws and legal standards applicable to national banks regarding the preemption of State law.[60]

The phrase "any successor officer or agency" is a reference to the OCC. Section 314 of the Dodd-Frank Act provides that the OTS's supervisory responsibilities with respect to federal thrifts will transfer to the OCC on July 21, 2011.[61]

Judicial Developments Beyond the NBA and HOLA

Other Laws

The provision in § 25b(b)(1)(C) of the NBA which says that a SCFL will be preempted for a national bank if the SCFL is preempted by a federal law other than the NBA[62] is a reminder that, while few other federal laws that regulate the financial services industry have had a preemptive scope as expansive as the NBA or HOLA, other federal laws do sometimes preempt state laws. The discussion below describes several important decisions addressing the preemptive effects of federal financial laws other than the NBA and HOLA.

55. Fid. Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 162 (1982).
56. 12 C.F.R. § 560.2 (2010).
57. *Id.* § 557.11(b).
58. *Id.* § 550.136.
59. Dodd-Frank Act, *supra* note 3, § 1046(a), 124 Stat. at 2017 (to be codified at 12 U.S.C. § 1465(b)).
60. *Id.* (to be codified at 12 U.S.C. § 1465(a)).
61. *Id.* § 314, 124 Stat. at 1523–24 (to be codified at 12 U.S.C. §§ 1, 4b); *see supra* note 5 and accompanying text.
62. *See supra* note 16 and accompanying text.

Higher Education Act

In *Chae v. SLM Corp.*,[63] the U.S. Court of Appeals for the Ninth Circuit held that student-loan borrowers' California state business, contract, and consumer-protection law claims were preempted by the Higher Education Act ("HEA"),[64] as to student-loan servicers.[65] The borrowers claimed that SLM Corp. (better known as "Sallie Mae") violated both California's Unfair Competition Law and Consumer Legal Remedies Act by making fraudulent representations in its billing statements and coupon books.[66] However, the court concluded that, "[a]t bottom, the plaintiffs' misrepresentation claims are improper-disclosure claims," and the HEA, at 20 U.S.C. § 1098g, provides that "[l]oans made, insured, or guaranteed pursuant to a program authorized by Title IV of the [HEA] . . . shall not be subject to any disclosure requirements of any State law."[67] Therefore, in *Chae* the borrowers' "restyled improper-disclosure claims [were] subject to express preemption under" the HEA.[68]

The borrowers also challenged Sallie Mae's imposition of late fees and its repayment start date.[69] The *Chae* court held that these state law claims were "conflict preempted" (i.e., preempted by reason of conflict with federal law) because they stood as "obstacle[s] to the . . . full purposes and objectives" of Congress for the HEA, which is regulatory uniformity among the states.[70] The court reasoned that "[i]f federal law permits late fees and gives up to sixty days for repayment, to say that state law prohibits late fees and requires a prompter repayment period is in conflict."[71]

Finally, in *Chae* the borrowers challenged Sallie Mae's method of interest calculation, arguing that the method Sallie Mae used conflicted with the terms of the loan documents, California law, and the Federal Family Education Loan Program.[72] In response, the Department of Education ("DOE") argued that Sallie Mae was required to use a particular method of interest calculation under federal law, and that the borrowers' claims posed an obstacle to the uniform implementation of HEA programs.[73] The court deferred to the DOE, finding its "interpretations of the likely effect of state law" on the HEA's programs to be "reasonable and within the DOE's statutory grant of authority."[74] Therefore, the court held the last claim to be preempted.[75]

63. 593 F.3d 936, 938 (9th Cir. 2010).
64. Higher Education Act, 89 Pub. L. No. 329, 79 Stat. 1219 (1965) (codified as amended at 20 U.S.C.A. §§ 1001–1155 (West 2010)).
65. *Chae*, 593 F.3d at 938.
66. *Id*. at 940.
67. *Id*. at 942–43 (quoting 20 U.S.C. § 1098g).
68. *Id*. at 943.
69. *Id*. at 938.
70. *Id*. at 943 (quoting Crosby v. Nat'l Foreign Trade Council, 520 U.S. 363, 373 (2000)).
71. *Id*. at 948.
72. *Id*. at 940.
73. *Id*. at 948–49.
74. *Id*. at 949.
75. *Id*. at 950.

Fair Credit Reporting Act

Most of the federal laws that regulate consumer financial services expressly provide that they establish only minimum standards of conduct for consumer financial service providers, and that states are free to supplement these federal standards with more stringent rules. The Fair Credit Reporting Act ("FCRA")[76] is a notable exception. Section 625 of the FCRA[77] contains provisions that broadly preempt many types of state laws that purport to regulate the collection, dissemination, and use of information about consumers.[78]

In *Wang v. Asset Acceptance, LLC*, the United States District Court for the Northern District of California dismissed, as preempted by section 625 of the FCRA, allegations that a furnisher failed to report a debt as "disputed," and failed to report that the statute of limitations on the debt had expired, in alleged violation of state law.[79]

However, in 2009, the United States Court of Appeals for the Ninth Circuit held that claims alleging inaccurate credit reporting brought pursuant to sections 1785.25(g) and 1785.31 of the California Civil Code are exempt from FCRA preemption.[80] The plaintiff in *Gorman* asserted that the defendant furnisher had violated California Civil Code section 1785.25(a) by failing to report his debt as "disputed" to the consumer reporting agencies.[81] The FCRA contains a special exemption from preemption for section 1785.25(a) of the California Civil Code,[82] which prohibits any person from "furnish[ing] information on a specific transaction or experience to any consumer credit reporting agency if the person knows or should know the information is incomplete or inaccurate."[83] However, it is sections 1785.25(g) and 1785.31 of the California Civil Code that provide a private cause of action for violations of section 1785.25(a)[84]—but section 625 of the FCRA does not mention either section 1785.25(g) or section 1785.31. The *Gorman* court held that, when a state statute defining requirements is exempted from preemption under the FCRA, a state statute that confers standing on private citizens to enforce those requirements is also not preempted.[85]

76. Pub. L. No. 91-508, tit. VI, 84 Stat. 1114, 1128 (1970) (codified as amended at 15 U.S.C.A. §§ 1681–1681x (West 2009 & Supp. 2010)).

77. 15 U.S.C. § 1681t (2006).

78. *Id.*

79. 681 F. Supp. 2d 1143, 1149 (N.D. Cal. 2010).

80. Gorman v. Wolpoff & Abramson, LLP, 584 F.3d 1147, 1173 (9th Cir. 2009).

81. *Id.* at 1152–53.

82. 15 U.S.C. § 1681t(b)(1)(F)(ii) (2006).

83. Cal. Civ. Code § 1785.25 (West 2010).

84. *Id.* § 1785.25(g) ("A person who furnishes information to a consumer credit reporting agency is liable for failure to comply with this section, unless the furnisher establishes by a preponderance of the evidence that, at the time of the failure to comply with this section, the furnisher maintained reasonable procedures to comply with those provisions."); *id.* § 1785.31(a) ("Any consumer who suffers damages as a result of a violation of this title by any person may bring an action in a court of appropriate jurisdiction against that person to" receive various remedies).

85. *Gorman*, 584 F.3d at 1172–73.

Arbitration Developments: Has the Supreme Court Finally Stepped In?

*By Alan S. Kaplinsky, Mark J. Levin, and Martin C. Bryce, Jr.**

Introduction

During the past year, although most federal courts have continued to enforce consumer arbitration agreements,[1] an increasing number of courts have shown hostility toward them, often basing such hostility on the existence of class action waivers[2] contained in such agreements.[3] Courts, and even the same court, have issued what appear to be conflicting rulings on whether arbitration agreements that include class action waivers are unconscionable as a matter of state law.[4]

In 2010, the United States Supreme Court finally entered the fray. In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*,[5] the Supreme Court held that parties could not be compelled to arbitrate on a class basis against their will. Although the Supreme Court's decision in *Stolt-Nielsen* did not squarely address the issues surrounding class action waivers,[6] its rationale—that arbitration is a matter of consent and class action arbitration "changes the nature of arbitration" with

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* Alan S. Kaplinsky, Mark J. Levin, and Martin C. Bryce, Jr. are partners with Ballard Spahr LLP in Philadelphia, Pennsylvania. Mr. Kaplinsky is a former Chair of the Committee on Consumer Financial Services and its Subcommittee on Alternative Dispute Resolution of the American Bar Association Section of Business Law. As noted more specifically in this survey, Ballard Spahr has represented certain parties in the litigation described herein. The views expressed in this survey are those of the authors and are not intended to represent the views of Ballard Spahr or its clients.

1. *See, e.g.*, Wood v. Palisades Collection, LLC, No. 09-4627 (SRC), 2010 WL 2950323, at *7 (D.N.J. July 22, 2010) (enforcing arbitration agreement containing class action waiver). Messrs. Kaplinsky and Bryce represented the defendant in *Wood*.

2. Class action waivers typically provide that neither party will have the right in court or in an arbitration proceeding to participate in a class action either as a class representative or a class member. *See, e.g.*, Gay v. CreditInform, 511 F.3d 369, 392–93 (3d Cir. 2007).

3. *See, e.g.*, Fensterstock v. Educ. Fin. Partners, 611 F.3d 124, 140–41 (2d Cir. 2010) (affirming denial of motion to compel where arbitration agreement contained class action waiver).

4. *Compare In re* Checking Account Overdraft Litig. (Johnson v. KeyBank Nat'l Ass'n), Nos. 1:10-cv-21176-JLK, 2:10-cv-304, 09-MD-02036-JLK, 2010 WL 2489976, at *7 (S.D. Fla. June 16, 2010) (MDL No. 2036) (denying arbitration), *with In re* Checking Account Overdraft Litig. (Gulley v. Huntington Bancshares Inc.), Nos. 09-MD-02036-JLK, 10-CV-23514-JLK, 09-CV-00880, 2010 WL 3389035, at *7 (S.D. Fla. May 25, 2010) (MDL No. 2036) (granting arbitration).

5. 130 S. Ct. 1758 (2010).

6. The arbitration agreement in *Stolt-Nielsen* was silent on the issue. *Id.* at 1775.

respect to its efficiency and speed, among other things[7]—undercuts the rationale of many of the cases invalidating class action waivers.

Any ambiguity remaining after *Stolt-Nielsen* is likely to end in 2011 as the Supreme Court has since granted certiorari in *Concepcion v. AT&T Mobility LLC*.[8] In *Concepcion*, it is expected that the Supreme Court will finally determine whether the Federal Arbitration Act ("FAA")[9] preempts the application of state laws used to invalidate class action waivers contained within arbitration agreements.[10]

Additionally, Congress passed financial reform in 2010 which, among other things, creates a new Bureau of Consumer Financial Protection ("CFPB") with sweeping powers, including the ability to regulate arbitration agreements in consumer financial services contracts.[11] How, and to what extent, the CFPB will regulate arbitration agreements is the subject of much anticipation.

2010 Saw a Number of Inconsistent Decisions on the Enforceability of Arbitration Agreements

In *Fensterstock v. Education Finance Partners*,[12] the plaintiff brought a putative class action contending that the defendants "engaged in fraudulent and deceptive practices in connection with the solicitation, consolidation, and servicing of student loans."[13] The plaintiff brought various claims under California law and the defendants moved to compel the individual arbitration of those claims.[14] The district court denied the defendants' arbitration motion and the U.S. Court of Appeals for the Second Circuit affirmed, finding the arbitration agreement unconscionable under California law because of its inclusion of a class action waiver.[15] The Second Circuit concluded that the arbitration agreement was procedurally unconscionable because "a clause presented to the weaker party on a take-it-or-leave-it basis without the opportunity for meaningful negotiation is, under California law, oppressive, and hence satisfies the requirement that there be at least

7. *Id.* at 1775–76.

8. Laster v. AT&T Mobility LLC, 584 F.3d 849 (9th Cir. 2009), *cert. granted sub nom.* AT&T Mobility LLC v. Concepcion, 130 S. Ct. 3322 (2010).

9. Ch. 392, 61 Stat. 669 (1947) (codified as amended at 9 U.S.C. §§ 1–16 (2006)).

10. The question presented by the certiorari petition in *Concepcion* is "[w]hether the Federal Arbitration Act preempts states from conditioning the enforcement of an arbitration agreement on the availability of particular procedures—here, class-wide arbitration—when those procedures are not necessary to ensure that the parties to the arbitration agreement are able to vindicate their claims." Petition for Writ of Certiorari, AT&T Mobility LLC v. Concepcion, No. 09-893, 2010 WL 304265, at *i (Jan. 25, 2010). A number of courts around the country have stayed actions dealing with the validity of arbitration agreements containing class action waivers pending a decision in *Concepcion*. *See, e.g.*, Kaltwasser v. Cingular Wireless LLC, No. C 07-00411 JF (PVT), 2010 WL 2557379, at *3 (N.D. Cal. June 21, 2010).

11. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. X, § 1028, 124 Stat. 1376, 1955, 2003–04 (2010) [hereinafter Dodd-Frank Act].

12. 611 F.3d 124 (2d Cir. 2010).

13. *Id.* at 127.

14. *Id.*

15. *Id.* at 141.

a minimal showing of procedural unconscionability."[16] The court also found the arbitration agreement substantively unconscionable because under California law it is "substantively unconscionable—and intolerable as a matter of public policy—to permit a party with superior bargaining power to use class action or class arbitration waiver clauses to insulate itself from remedial action when it is alleged to have 'deliberately cheat[ed] large numbers of consumers out of individually small sums of money.'"[17]

Conversely, the U.S. Court of Appeals for the Third Circuit recently enforced an arbitration agreement containing a class action waiver in *Kaneff v. Delaware Title Loans, Inc.*[18] In *Kaneff*, the plaintiff traveled from Pennsylvania to Delaware to obtain what is commonly referred to as an "auto title loan."[19] The plaintiff brought a putative class action contending that the terms of the loan violated Pennsylvania usury law and the defendant moved to compel the individual arbitration of the plaintiff's claims.[20] The Third Circuit, applying Pennsylvania law, affirmed the district court's grant of the defendant's motion to compel arbitration.[21] Notwithstanding that the amount of the consumer's damages claim was less than $900, the court concluded that the arbitration agreement was not unconscionable because of the inclusion of a class action waiver.[22]

The district court in the multi-district *Checking Account Overdraft Litigation* has issued two decisions invalidating arbitration agreements with class action waivers and one decision upholding the same. In this multi-district litigation, the plaintiffs claim that, in violation of various state laws, numerous banks charged excessive overdraft fees for charges made to their accounts on debit card transactions.[23] Five different banks filed motions to compel arbitration which the district court denied.[24] The district court found the arbitration agreements of each of those banks procedurally unconscionable because there was "no indication" that they had been specifically disclosed to the plaintiffs, they had been presented on a "take-it-or-leave it" basis, and there was a disparity of bargaining power.[25] The

16. *Id.* at 138. Under the laws of virtually every state, in order to establish unconscionability, the party opposing arbitration must establish both procedural and substantive unconscionability. *See, e.g.*, Harris v. Green Tree Fin. Corp., 183 F.3d 173, 181 (3d Cir. 1999). Under California law, "procedural unconscionability and substantive unconscionability . . . need not be present in the same degree. . . . In other words, the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa." *Fensterstock*, 611 F.3d at 135–36 (emphasis omitted).

17. *Id.* at 139 (quoting Discover Bank v. Superior Court, 113 P.3d 1100, 1110 (Cal. 2005)).

18. 587 F.3d 616 (3d Cir. 2009). Messrs. Kaplinsky and Levin represented the defendant in *Kaneff*.

19. *Id.* at 618. The loan was secured by the title to the plaintiff's car, was in the amount of $550 with an additional finance charge of $135.62, and had to be paid back within thirty days. *Id.*

20. *Id.* at 618–19.

21. *Id.* at 621–24.

22. *Id.* at 624.

23. *See In re* Checking Account Overdraft Litig., 694 F. Supp. 2d 1302, 1307 (S.D. Fla. 2010) (denying motions to dismiss filed by various banks).

24. *In re* Checking Account Overdraft Litig. (Powell-Perry v. Branch Banking & Trust Co.), No. 10-CV-20820-JLK, 2010 WL 3389034, at *11 (S.D. Fla. May 10, 2010) (MDL No. 2036).

25. *Id.* at *2.

court found the arbitration agreements substantively unconscionable given the small damages at issue—the average single overdraft fee was $35—and the fact that the various state statutes under which the plaintiffs brought their claims did not guarantee an award of counsel fees to the successful plaintiff.[26] With respect to two of the arbitration agreements at issue, the district court feared that an unsuccessful plaintiff might even be required to reimburse the defendant for its fees and costs.[27]

In a subsequent decision in the *Checking Account Overdraft Litigation*, the court refused to enforce the arbitration agreement of another bank under Washington law.[28] The court concluded that the arbitration agreement with its class waiver was substantively unconscionable because it effectively shielded the defendant bank from all liability.[29] In finding the arbitration agreement unconscionable, the district court rejected the argument that an "opt-out provision"[30] rendered the agreement enforceable.[31] The court's decision turned on the fact that under Washington law, unlike the law of most states, "a court may invalidate a provision of an Agreement if it is either substantively or procedurally unconscionable."[32] As a result, the court concluded that the opt-out right did not affect its determination of substantive unconscionability and it invalidated the agreement on that basis.[33]

The *Overdraft Litigation* court reached a different conclusion in yet another case applying Ohio law.[34] The court first concluded that the arbitration agreement was procedurally unconscionable because it had been presented to the plaintiff on a "take-it-or-leave-it" basis and was inconspicuous.[35] The court determined, however, that the arbitration agreement was not substantively unconscionable and, thus, was enforceable.[36] The court distinguished this matter from its previ-

26. *Id.* at *2–3.

27. *Id.* at *7.

28. *In re* Checking Account Overdraft Litig. (Johnson v. KeyBank Nat'l Ass'n), Nos. 1:10-cv-21176-JLK, 2:10-cv-304, 09-MD-02036-JLK, 2010 WL 2489976, at *7 (S.D. Fla. June 16, 2010) (MDL No. 2036).

29. *Id.* at *4.

30. An "opt-out provision" generally gives the consumer the unconditional right to opt out of the arbitration agreement. *Id.* at *6. A large number of courts have concluded that such a provision negates any argument as to procedural unconscionability. *See, e.g.*, Clerk v. Ace Cash Express, Inc., No. 09-05117, 2010 WL 364450, at *8–9 (E.D. Pa. Jan. 29, 2010); Credit Acceptance Corp. v. Davisson, 644 F. Supp. 2d 948, 958 (N.D. Ohio 2009); Cicle v. Chase Bank USA, 583 F.3d 549, 555 (8th Cir. 2009); Circuit City Stores, Inc. v. Ahmed, 283 F.3d 1198, 1199–1200 (9th Cir. 2002). Messrs. Kaplinsky and Bryce represented the lender in *Davisson*. Messrs. Kaplinsky and Levin represented the defendant in *Clerk*.

31. *Checking Account Overdraft Litig. (Johnson)*, 2010 WL 2489976, at *6.

32. *Id.* at *3.

33. *Id.* at *6.

34. *In re* Checking Account Overdraft Litig. (Gulley v. Huntington Bancshares Inc.), Nos. 09-MD-02036-JLK, 10-CV-23514-JLK, 09-CV-00880, 2010 WL 3389035 (S.D. Fla. May 25, 2010) (MCL No. 2036). Messrs. Kaplinsky and Bryce represented the defendant in this matter.

35. *Id.* at *3. The court found the arbitration agreement inconspicuous because Gulley had opened her checking account over the internet and would have had to scroll through multiple screens before reaching the arbitration agreement. *Id.*

36. *Id.* at *4. Under the applicable Ohio law, the plaintiff was required to show both procedural and substantive unconscionability. *Id.*

ous decision denying arbitration, explaining that "[u]nder the facts in this case, the Court finds that the potential costs of arbitrating a claim would not deter potential plaintiffs from seeking to vindicate their rights in an arbitral forum."[37] The court rested its decision on the facts that the state statute at issue provided for the mandatory award of counsel fees to the successful plaintiff and under the terms of the arbitration agreement, the defendant would cover all of the costs of arbitration.[38]

The Supreme Court Begins to Provide the Needed Clarity

In *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, the defendant moved to vacate an arbitration award that had concluded that the arbitration clause would permit a class arbitration.[39] The parties in *Stolt-Nielsen* stipulated that they had reached "no agreement" on the issue of class arbitration and the arbitration agreement was silent on the issue.[40] The Supreme Court held that the arbitration panel impermissibly required Stolt-Nielsen, the party seeking to avoid class arbitration, to "establish that the parties to the charter agreements intended to *preclude* class arbitration."[41]

The Supreme Court began its analysis in *Stolt-Nielsen* by clarifying some misconceptions of the parties and the lower courts concerning the Court's prior decision in *Green Tree Financial Corp. v. Bazzle*.[42] The Court explained that "*Bazzle* did not establish the rule to be applied in deciding whether class arbitration is permitted."[43] Rather, the Court explained in *Stolt-Nielsen*, *Bazzle* was a non-precedential decision because a majority of the justices did not share common reasoning in reaching its result "that the arbitrator and not a court should decide whether the contracts were indeed 'silent' on the issue of class arbitration."[44]

In *Stolt-Nielsen*, the Supreme Court noted that "the central or 'primary' purpose of the FAA is to ensure that 'private agreements to arbitrate are enforced accord-

37. *Id*.

38. *Id*. at *4–5. In *Pellett v. TCF Bank, N.A.*, No. 10-3943 (DSD/FLN) (D. Minn. Nov. 24, 2010), yet another overdraft fee case, the court reversed the previous order of the magistrate judge who had granted the plaintiffs' motion to stay the action—and had declined to address TCF's motion to compel individual arbitration—pending a transfer decision by the MDL Panel. The court granted TCF's motion to compel individual arbitration, enforcing the class action waiver, and stayed all proceedings pending the completion of arbitration. Messrs. Kaplinsky and Levin represented the defendant in this matter.

39. 130 S. Ct. 1758, 1766 (2010).

40. *Id*. at 1775.

41. *Id*. (internal quotations omitted).

42. *See id*. at 1772 (noting that "the opinions in *Bazzle* appear to have baffled the parties in this case." (citing Green Tree Fin. Corp. v. Bazzle, 539 U.S. 444 (2003)). Messrs. Kaplinsky and Levin were counsel to Green Tree in *Bazzle*.

43. *Id*. at 1772.

44. *Id*. at 1771. In *Bazzle*, the contracts did not expressly mention class arbitration. 539 U.S. at 444. The South Carolina Supreme Court had concluded in that case that the arbitration agreements were in fact "silent" on class arbitration and in such circumstances class arbitration could be compelled. *Id*. The U.S. Supreme Court in a plurality decision reversed that determination—concluding the issue was for the arbitrator. *Id.* at 452.

ing to their terms.'"[45] The Court recognized that "[w]hile the interpretation of an arbitration agreement is generally a matter of state law, the FAA imposes certain rules of fundamental importance, including the basic precept that arbitration 'is a mater of consent, not coercion.'"[46] The Court then concluded that "a party may not be compelled under the FAA to submit to class arbitration unless there is a contractual basis for concluding that the party *agreed* to do so."[47] The Supreme Court explained that requiring class arbitration as a matter of state public policy "is fundamentally at war with the foundational FAA principle that arbitration is a matter of consent."[48]

In reaching its decision in *Stolt-Nielsen*, the Supreme Court adopted a central argument made by defendants seeking to enforce arbitration agreements with bans on class action arbitration: "[C]lass-action arbitration changes the nature of arbitration to such a degree that it cannot be presumed the parties consented to it by simply agreeing to submit their disputes to an arbitrator."[49] The Court further explained that "[i]n bilateral arbitration, parties forego the procedural rigor and appellate review of the courts in order to realize the benefits of private dispute resolution: lower costs, greater efficiency and speed, and the ability to choose expert adjudicators to resolve specialized disputes."[50] In contrast, the Court explained, class arbitration would not impart such benefits.[51]

The Supreme Court subsequently vacated the decision of the Second Circuit in *In re American Express Merchants' Litigation*[52] and remanded the matter for further consideration in light of its decision in *Stolt-Nielsen*.[53] In *American Express*, the Second Circuit had invalidated an arbitration agreement with a class action waiver in contracts between American Express and merchants accepting its credit cards who had brought an antitrust action against it.[54]

Courts invalidating express class action waivers have done so at least in part on the assumption that "class proceedings will [not] reduce the efficiency and expeditiousness of arbitration in general."[55] The Supreme Court's decision in *Stolt-Nielsen* appears, at the very least, to undercut that rationale by recognizing the incompatibilities between arbitration and class actions. Furthermore, *Stolt-Nielsen* also appears to undercut the basic premise of those authorities holding that an arbitration agreement must permit class arbitration in order to be enforceable because such a contention seems incompatible with "the basic precept" and "the fun-

45. *Stolt-Nielsen*, 130 S. Ct. at 1773 (citations omitted).
46. *Id*. (citation omitted).
47. *Id*. at 1775.
48. *Id*.
49. *Id*.
50. *Id*.
51. *Id*. at 1776.
52. 554 F.3d 300 (2d Cir. 2009), *vacated sub nom*. Am. Express Co. v. Italian Colors Rest., 130 S. Ct. 2401 (2010).
53. *Am. Express Co*., 130 S. Ct. at 2401 (citing *Stolt-Nielsen*, 130 S. Ct. 1758).
54. *Am. Express Merchants' Litig*., 554 F.3d at 316–20.
55. Shroyer v. New Cingular Wireless Servs., Inc., 498 F.3d 976, 990 (9th Cir. 2007) (invalidating an arbitration agreement with a class action waiver).

damental FAA principle" that "arbitration is a matter of consent, not coercion."[56] To date, no court has applied the rationale of *Stolt-Nielsen* to conclude that the FAA mandates the enforceability of class action waivers or otherwise preempts state laws that would invalidate the same.[57]

The Supreme Court is expected finally to decide whether the FAA preempts state laws invalidating arbitration agreements containing class action waivers in *Concepcion*.[58] In the underlying case, the plaintiff had brought a putative class action contending that the defendant's offer of a "free" telephone to anyone who signed up for its services was fraudulent to the extent the customer was charged a sales tax on the retail value of the phone.[59] The agreement between the plaintiff and the defendant contained an arbitration agreement that included a class action waiver and provided that the defendant would pay the customer $7,500 and double the reasonable attorney's fees, if the arbitrator issued an award greater than its last written settlement offer before the arbitrator was selected.[60] The U.S. Court of Appeals for the Ninth Circuit concluded that the arbitration agreement was unconscionable under California law because the underlying agreement was a contract of adhesion, the dispute involved a small amount of damages, and the defendant was alleged to have carried out a scheme to cheat a large number of customers out of small sums of money.[61] The court concluded that the premium provision did not negate the finding of unconscionability because the defendant could simply pay the face value of the claim before the selection of an arbitrator to avoid potentially paying the $7,500.[62]

The Ninth Circuit further concluded that the FAA does not preempt California law.[63] First, the court held that the FAA does not expressly preempt California law because unconscionability is a generally applicable contract defense under section 2 of the FAA.[64] Second, the court found the FAA does not implicitly preempt California law because it places arbitration agreements with class action waivers on the same footing as contracts that bar class action litigation outside the context of

56. *See Stolt-Nielsen*, 130 S. Ct. at 1773 (citation omitted).

57. In a non-published opinion, the U.S. Court of Appeals for the Third Circuit concluded that *Stolt-Nielsen* was inapposite to the issue of whether an arbitration agreement containing an express class action waiver could be invalidated under state law. Litman v. Cellco P'ship, 381 F. App'x 140, 143 n.5 (3d Cir. 2010).

58. *See supra* notes 8–10 and accompanying text.

59. Laster v. AT&T Mobility LLC, 584 F.3d 849, 852 (9th Cir. 2009), *cert. granted sub nom*. AT&T Mobility LLC v. Concepcion, 130 S. Ct. 3322 (2010).

60. *Id*. at 853.

61. *Id*. at 855.

62. *Id*. at 855–56. A number of courts have enforced arbitration agreements—including the very agreement at issue in *Concepcion*—that contained class action waivers with such premium provisions. *See, e.g.*, Wince v. Easterbrooke Cellular Corp., 681 F. Supp. 2d 679, 685 (N.D. W. Va. 2010).

63. *Laster*, 584 F.3d at 856–57.

64. *Id*. at 857. Section 2 of the FAA provides, in pertinent part, that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2 (2006).

arbitration.[65] The Ninth Circuit also rejected the argument that class proceedings would reduce the efficiency and speed of arbitration.[66]

Finally, the Supreme Court also issued its much anticipated decision in *Rent-A-Center, West, Inc. v. Jackson*[67] in 2010. The plaintiff in *Jackson* had brought an employment discrimination claim against his former employer, who responded with a motion to compel arbitration.[68] The arbitration agreement contained a "delegation provision" providing that "[t]he Arbitrator . . . shall have exclusive authority to resolve any dispute relating to the . . . enforceability . . . of this Agreement including, but not limited to any claim that all or any part of this Agreement is void or voidable."[69] Based on that provision, the defendant contended that the plaintiff's argument that the arbitration agreement as a whole was unconscionable was for the arbitrator to decide.[70] The district court agreed but the Ninth Circuit reversed.[71] The Supreme Court initially noted that "[w]e have recognized that parties can agree to arbitrate 'gateway' questions of 'arbitrability,' such as whether the parties have agreed to arbitrate or whether their agreement covers a particular controversy."[72] The Supreme Court then concluded that the plaintiff's unconscionability argument was directed to the arbitration agreement as a whole and not to the delegation provision in particular and therefore could not be considered by the courts under *Buckeye Check Cashing, Inc. v. Cardegna*[73] and *Prima Paint Corp. v. Flood & Conklin Mfg. Co*.[74] In *Rent-A-Center*, the Supreme Court recognized that the underlying contract at issue was an arbitration agreement, but concluded that did not make a difference:

> To be sure this case differs from *Prima Paint, Buckeye*, and *Preston* [*v. Ferrer*, 552 U.S. 346 (2008)] in that the arbitration provisions sought to be enforced in those cases were contained in contracts unrelated to arbitration—contracts for consulting services, see *Prima Paint*, check-cashing services, see *Buckeye*, and "personal management" or "talent agent" services, see *Preston*. In this case, the underlying contract is itself an arbitration agreement. But that makes no difference.[75]

65. *Laster*, 584 F.3d at 858.
66. *Id*.
67. 130 S. Ct. 2772 (2010).
68. *Id*. at 2775.
69. *Id*. at 2777.
70. *Id*. at 2775.
71. *Id*. at 2775–76.
72. *Id*. at 2777.
73. 546 U.S. 440 (2006).
74. 388 U.S. 395 (1967). In *Rent-A-Center*, the Supreme Court explained that in *Cardegna* and *Prima Paint* it had recognized that: "There are two types of validity challenges under § 2: 'One type challenges specifically the validity of the agreement to arbitrate,' and '[t]he other challenges the contract as a whole, either on a ground that directly affects the entire agreement (*e.g.*, the agreement was fraudulently induced), or on the ground that the illegality of one of the contract's provisions renders the whole contract invalid.'" *Rent-A-Center*, 130 S. Ct. at 2778 (quoting *Cardegna*, 546 U.S. at 444). The Court further explained that in those cases it "held that only the first type of challenge is relevant to a court's determination whether the arbitration agreement at issue is enforceable." *Id*.
75. *Rent-A-Center*, 130 S. Ct. at 2779 (internal citations omitted).

Therefore, the Supreme Court concluded, since the plaintiff did not challenge the delegation provision but only challenged the arbitration agreement as a whole, the unconscionability arguments were for the arbitrator.[76]

Rent-A-Center appears to mark an expansion of what has become known as the *Prima Paint* Rule.[77] Prior to the Supreme Court's decision in *Rent-A-Center*, many authorities had concluded that the rule established by *Cardegna* and *Prima Paint* applied only to challenges directed at the transaction or agreement containing the arbitration agreement.[78] However, the Supreme Court has now made it clear that challenges directed to an arbitration agreement as a whole are similarly for the arbitrator under *Cardegna* and *Prima Paint*.[79]

Congressional Action and the Possible Prohibition of Arbitration Agreements

In July 2010, Congress potentially upended existing consumer financial services law by enacting comprehensive legislation that includes potent new governmental authority to create rules and remedies to redress violations of laws protecting consumers of financial products and services.[80] The Consumer Financial Protection Act of 2010, passed as Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"),[81] establishes a new Bureau of Consumer Financial Protection (the "CFPB") as an independent branch of the Federal Reserve Board.

The CFPB is responsible for supervising and examining the consumer compliance of depository institutions with more than $10 million in assets, most participants in the mortgage lending industry, student and payday lenders, larger participants in markets for other financial services, and companies engaged in conduct deemed to pose risks for consumers.[82] Additionally, the CFPB has sweeping authority to issue rules, applicable to virtually all providers of consumer financial products and services, identifying as unlawful acts or practices it defines as "unfair, deceptive, or abusive" in connection with the offer or provision of a consumer financial product or service to a consumer.[83]

With respect to arbitration, the CFPB, after the "designated transfer date,"[84] is specifically empowered to "conduct a study of, and shall provide a report to Con-

76. *Id*. at 2779–80. The Supreme Court refused to consider the plaintiff's contention that the delegation provision was itself unconscionable—an argument that would not have been barred by *Cardegna* and *Prima Paint* because it was directed at a particular provision of the arbitration agreement—as he failed to raise it in the U.S. District Court and the Ninth Circuit. *Id*. at 2781.

77. *See supra* notes 75–76 and accompanying text.

78. *See Rent-A-Center*, 130 S. Ct. at 2781–82 (Stevens, J., dissenting).

79. *Id*.

80. *See supra* note 11 and accompanying text.

81. Dodd-Frank Act, *supra* note 11, §§ 1001–1100H, 124 Stat. at 1955–2113.

82. *Id*. §§ 1024–1026, 124 Stat. at 1987–95 (to be codified at 12 U.S.C. §§ 5514–5516).

83. *Id*. § 1031, 124 Stat. at 2005–06 (to be codified at 12 U.S.C. § 5531).

84. This is a date set by the Secretary of the Treasury, required to be between six and eighteen months from enactment on July 21, 2010. *Id*. § 1029A, 124 Stat. at 2005 (to be codified at 12 U.S.C. § 5511 note). The designated transfer date of July 21, 2011, was announced on September 20, 2010. *See* Designated Transfer Date, 75 Fed. Reg. 57252, 57252 (Sept. 20, 2010).

gress concerning, the use of agreements providing for arbitration of any future dispute between covered persons and consumers in connection with the offering or providing of consumer financial products or services."[85] The CFPB is also authorized to impose limits or conditions upon the use of pre-dispute arbitration agreements.[86]

The CFPB may consider, as part of its rulemaking process, limitations or an outright ban on the inclusion of arbitration agreements in consumer contracts subject to its jurisdiction.[87] Any such regulations can apply only to agreements entered into more than 180 days after the regulation's effective date.[88] Consequently, the Supreme Court may not have the last word after all.

Finally, the Dodd-Frank Act leaves no doubt with respect to one type of arbitration agreement as it explicitly bars the use of pre-dispute arbitration in consumer mortgages.[89]

85. Dodd-Frank Act, *supra* note 11, § 1028(a), 124 Stat. at 2003–04 (to be codified at 12 U.S.C. § 5518(a)).

86. *Id.* § 1028(b), 124 Stat. at 2004 (to be codified at 12 U.S.C. § 5518(b)).

87. *Id.* § 1028(c), 124 Stat. at 2004 (to be codified at 12 U.S.C. § 5518(c)).

88. *Id.* § 1028(d), 124 Stat. at 2004 (to be codified at 12 U.S.C. § 5518(d)).

89. *Id.* § 1414(e)(1), 124 Stat. at 2151 (to be codified at 15 U.S.C. § 1639c(e)(1)). It is unclear whether this section became effective on July 22, 2010 (one day after the enactment of the Dodd-Frank Act) pursuant to section 4 of the Dodd-Frank Act or will become effective only eighteen months after the designated transfer date pursuant to section 1400(c)(3), which provides "[a] section of this title for which regulations have not been issued on the date that is 18 months after the designated transfer date shall take effect on such date." *Id.* § 1400(c)(3), 124 Stat. at 2136 (to be codified at 15 U.S.C. § 1601 note).

Update on Loan Modification Litigation

*By Richard E. Gottlieb and Brett J. Natarelli**

Introduction

Loan modification litigation is part of the current wave in consumer finance litigation. With the near collapse of the residential real estate market in 2008, and lingering fallout at least through 2010,[1] origination-based lawsuits against loan originators alleging predatory lending have slowed dramatically. Many of the major players in subprime lending have ceased to exist, and even more of the smaller players have disappeared.[2] With the originators gone or otherwise deemed judgment proof, borrowers' attorneys are now advancing new theories to defend against the dramatic uptick in foreclosures.[3] As noted in this survey, the plaintiffs' bar has concentrated much of its efforts against loan servicers who, for the most part, are immune from direct liability for the origination practices of others. While servicers may face foreclosure defenses or affirmative claims based on the Truth in Lending Act ("TILA")[4] or the Real Estate Settlement Procedures Act ("RESPA")[5] or the like,[6] borrowers have also begun filing claims under a variety of new theories centered on the idea that the borrower somehow has a right to

* Richard E. Gottlieb is a member and Brett J. Natarelli an associate in Dykema Gossett PLLC. Dykema Gossett PLLC represents many of the companies described in the cases below, and the authors represented OneWest Bank, F.S.B. in *Fletcher v. IndyMac Mortgage Services, FSB*, cited in this survey. The views expressed in this survey are those of the authors and are not intended to represent the views of their firm or their clients.

1. *See*, *e.g.*, Alvin C. Harrell, *The Great Credit Contraction: Who, What, When, Where and Why*, 26 Ga. St. U. L. Rev. 1209 (2010); Kathleen E. Keest, *Consumer Financial Services Law and Policy: 1968–20?? In the Thick of the Battlefield for America's Economic Soul*, 26 Ga. St. U. L. Rev. 1087 (2010); Donald C. Lampe, Fred H. Miller & Alvin C. Harrell, *Introduction to the 2009 Annual Survey of Consumer Financial Services Law*, 64 Bus. Law. 465 (2009).

2. In effect, the mortgage markets have been nationalized, as private sources of mortgage credit have dried up. *See*, *e.g.*, Harrell, *supra* note 1, at 1209–10, 1238–48.

3. *See generally* Martin C. Bryce, Jr., *Foreclosure Developments, Mortgage Fraud, Counterclaims and Defenses*, 64 Consumer Fin. L.Q. Rep. 4 (2010).

4. Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C.A. §§ 1601–1667f (West 2009 & Supp. 2010)); *see also* 12 C.F.R. pt. 226 (2010) (Federal Reserve Board Regulation Z); Catherine M. Brennan, Jeffrey P. Naimon & Jacqueline A. Parker, *Truth in Lending Update—2010*, 66 Bus. Law. 413 (2011) (in this *Annual Survey*).

5. Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified as amended at 12 U.S.C. §§ 2601–2617 (2006)); *see*, *e.g.*, John P. Kromer, Sanford Shatz & Jonathan W. Cannon, *2010 Survey of RESPA Developments*, 66 Bus. Law. 435 (2011) (in this *Annual Survey*).

6. *See generally* Bryce, *supra* note 3 (listing other defenses).

a loan modification, or that the borrower was otherwise harmed during the loan modification process.[7]

A loan modification, broadly defined, reduces or delays loan payments on an existing loan in order to make the loan more affordable for the borrower, and to avoid default.[8] Related, but somewhat different, are forbearance plans in which the monthly payments are reduced or forgiven on a temporary basis to allow the borrower to return to currency; the borrower then usually resumes making the original payments. Servicers may provide these benefits by reducing the interest rate, extending the loan term, rearranging the timing of payments, reducing the loan principal, or some combination of the above.

In 2009, the Obama Administration instituted the Home Affordable Modification Program ("HAMP"), along with a variety of similar subprograms.[9] As explained below, borrowers have now begun to invoke HAMP and its progeny as the basis for a right to a loan modification and, in addition, are articulating a variety of common law theories that they claim create a right to a loan modification. This survey discusses this broad trend and describes the near universal dismissal of such claims.

This discussion begins by describing the landmark HAMP program in general, before discussing many of the cases where courts have held that the borrowers possess no private right of action for its enforcement, and no right to a loan modification even if they qualify under HAMP's guidelines. The survey then describes

7. *See infra* notes 30–68 and accompanying text.

8. *See*, *e.g.*, Stephen F.J. Ornstein, Matthew S. Yoon & John P. Holahan, *The FHA Home Affordable Modification Loss Mitigation Option*, 63 Consumer Fin. L.Q. Rep. 289, 289 (2009).

9. *See*, *e.g.*, HAMP Supplemental Directive 09-01, at 1 (Apr. 6, 2009), *available at* http://www.hppinc.org/_uls/resources/Supplemental_Directive_09-0.pdf [hereinafter SD 09-01]. The subprograms are myriad, and include modification programs for second mortgages (called "2MP"), special provisions for unemployed borrowers who lack income (they can receive a short moratorium on payments as part of the "UP" program), refinancing for borrowers who are underwater ("FHA2LP"), and short sale incentives ("HAFA"). *See* Home Affordable Modification Program, https://www.hmpadmin.com/portal/index.html (under the "Programs" tab) (last visited Oct. 18, 2010). More such programs are likely forthcoming. All of these programs fall under the United States Treasury's jurisdiction and are part of the broader "Making Home Affordable" program, of which HAMP is the flagship. *Id.* In addition, there are numerous sub-guidelines depending on whether the loan is FHA insured or owned by one of the GSEs, Fannie Mae or Freddie Mac. Fannie Mae, for example, offers a program called "Alt-Mod" in which otherwise ineligible borrowers can qualify for a HAMP-like loan modification if they were offered a HAMP trial and made trial period payments on time. *See* Fannie Mae, Frequently Asked Questions: Lender Letter LL-2010-04; Fannie Mae's Alternative Modification to the Home Affordable Mortgage Program (June 3, 2010), *available at* https://www.efanniemae.com/sf/servicing/altmod/pdf/llaltmodfaqs.pdf.

For all of these subprograms, the general concepts are the same, i.e., monthly payments at 31 percent of monthly gross income for some period of time, with government incentives, and no servicer being required to take unprofitable actions. *Id.* Further details are noted below, but are otherwise beyond the scope of this survey. The reader should simply be aware that more specialized guidelines may be applicable in particular cases. *See*, *e.g.*, Ornstein, Yoon & Holahan, *supra* note 8, at 295–304 (describing FHA-HAMP in detail). Finally, it bears noting that some pre-HAMP legacy programs remain in effect, such as the Hope for Homeowners Program. *See*, *e.g.*, Stephen F.J. Ornstein, Matthew S. Yoon, David A. Tallman & John P. Holahan, *The Housing and Economic Recovery Act of 2008*, 61 Consumer Fin. L.Q. Rep. 944, 947–48 (2007).

how borrowers have attempted to pursue constitutional, statutory, and common law claims outside of HAMP as the basis for a right to a loan modification, including allegations of constitutional violations, racial discrimination in modifying loans, and false advertising by servicers in offering the possibility of a loan modification. As discussed below, these causes of action also have largely been dismissed.

Finally, this survey provides commentary on some of the new theories that are only now beginning to be asserted and have yet to work their way through the courts, including lawsuits by investors to stop or recoup their losses from loan modifications, and lawsuits based on a failure to send adverse action notices under the Equal Credit Opportunity Act ("ECOA").[10]

Overview of HAMP

Introduction

In early 2009, the United States Department of the Treasury ("Treasury") first announced HAMP, a national modification program intended to help three to four million at-risk homeowners avoid defaulting on their mortgage loans by reducing their monthly loan payments.[11] Servicers voluntarily enter the HAMP program by executing a Servicer Participation Agreement ("SPA") "with Fannie Mae in its capacity as financial agent for the United States."[12] On August 20, 2010, the Treasury published a servicer manual that contains detailed program guidelines for HAMP.[13]

What Does HAMP Do for Homeowners?

Greatly simplified, HAMP reduces a borrower's monthly payment to 31 percent of his or her pre-tax monthly income (a number the government considers presumptively affordable).[14] Under the guidelines in effect at the time of this writing, HAMP accomplishes this by reducing the interest rate to as low as 2 percent, extending the term to up to forty years, and forbearing up to $30,000 in principal.[15] If,

10. *See infra* notes 69–84 and accompanying text; Laura C. Baucus, Joseph H. Hickey & Michael J. Blalock, *Emerging Topic: Is a Loan Modification "Credit" Under the Equal Credit Opportunity Act? According to the Fed, It Is*, 64 Consumer Fin. L.Q. Rep. 155 (2010).

11. *See* SD 09-01, *supra* note 9, at 1.

12. *Id*. For a list of current HAMP servicers, see *Mortgage Servicer List*, Making Home Affordable, http://www.makinghomeaffordable.gov/contact_servicer.html (last visited Oct. 18, 2010). A template servicer participation agreement may be reviewed at *Home Affordable Modification Program: Servicer Participation Agreement*, Making Home Affordable, https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/servicerparticipationagreement.pdf (last visited Dec. 2, 2010).

13. *See* Making Home Affordable Program: Handbook for Servicers of Non-GSE Mortgages (Sept. 22, 2010), *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/mhahandbook_20.pdf [hereinafter Servicer Manual].

14. *Id*. at 37–38.

15. *Id*. at 37–41. The process followed is referred to as "The Waterfall." *Id*. at 37.

after making those changes to the loan terms, a 31 percent payment cannot be achieved, the loan does not qualify for HAMP.[16] In addition, after making those changes, the servicer or lender performs a net present value ("NPV") test to determine whether it would be more profitable to modify the loan at those terms or simply to foreclose.[17] If foreclosure is more profitable, the loan does not qualify for HAMP.[18] HAMP provides substantial government subsidies to borrowers who successfully make the modified payments, and to the investors on the loan who suffer the loss from a reduced payment stream; loan servicers receive a small incentive as partial compensation for processing the application and coordinating the modification paperwork.[19]

Assuming the borrower meets the HAMP qualifications, the borrower will be placed into what is called a HAMP Trial Period Plan ("TPP").[20] During the TPP, the borrower makes three or more trial payments at the proposed modification amount.[21] If the borrower makes the payments and otherwise remains qualified, the HAMP TPP converts to a permanent modification.[22] Prior to June 1, 2010, borrowers could be placed into a TPP based on stated income alone, while permanent modifications could only be generated based on verified income.[23] This often resulted in borrowers mistakenly believing they had qualified for the program initially only to be disqualified from the program once their true income was verified.[24]

16. *Id.*

17. *Id.* at 43.

18. *Id.* at 43–46 (describing the NPV test).

19. *Id.* at 59. "Borrowers whose monthly payment . . . is reduced through the HAMP by six percent or more and who make timely monthly payments will earn . . . the lesser of: (1) $1,000 . . . or (ii) [o]ne-half of the reduction in the borrower's annualized monthly payment for each month a timely payment is made." *Id.* Investors receive 50 percent of the difference between original and modified payments (with some complicated exceptions). *Id.* Servicers currently receive a flat $1,000 for every loan permanently modified under HAMP. *Id.* at 58.

20. *Id.* at 46–47 (describing the TPP).

21. *Id.* at 46.

22. *Id.*

23. HAMP Supplemental Directive 10-01, at 1 (Jan. 28, 2010), *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/sd1001.pdf [hereinafter SD 10-01].

24. Borrowers have filed lawsuits in Massachusetts, Illinois, and elsewhere, alleging that the TPP contractually promises a permanent loan modification. *See infra* notes 37–39 and accompanying text. However, the HAMP guidelines explicitly state otherwise, and courts repeatedly have held that HAMP lacks an enforcement mechanism. In the Massachusetts and Illinois cases, the plaintiffs have attempted to circumvent the rulings by pleading state and common law claims. Cases filed in the U.S. District Court for the District of Massachusetts include the following: Belyea v. Litton Loan Servicing, LLP, No. 10-10931 (D. Mass. filed June 4, 2010); Durmic v. J.P. Morgan Chase Bank, N.A., No. 10-10380 (D. Mass. filed Mar. 3, 2010); Bosque v. Wells Fargo Bank, N.A., No. 10-10311 (D. Mass. Feb. 23, 2010); Johnson v. BAC Home Loans Servicing, LP, No. 10-10316 (D. Mass. filed Feb. 23, 2010). Cases filed in the U.S. District Court for the Northern District of Illinois include the following: Wigod v. Wells Fargo Bank, N.A., No. 10-2348 (N.D. Ill. filed Apr. 15, 2010); Fletcher v. IndyMac Mortg. Servs., FSB, No. 10-04682 (N.D. Ill. filed July 27, 2010). Under the latest HAMP guidelines, a servicer may not offer a TPP to a borrower until first fully verifying the borrower's income. *See* Servicer Manual, *supra* note 13, at 28–29. This change in the HAMP guidelines may moot these lawsuits.

Other Limits on HAMP

Some borrowers and members of the public mistakenly view HAMP as creating a kind of automatic or legal right to a loan modification, perhaps because the media has sometimes advanced that perception. As just one notable example, a former "Real Housewives of Orange County" star reportedly was shocked and "incensed" to discover that her $4.5 million residence did not qualify for HAMP.[25] However, HAMP sets a maximum property value well under one million dollars for single family homes to qualify.[26] In addition to the strict qualification requirements, borrowers who enter the HAMP program must send in documents to verify their income at multiple times to ensure that the financial information is current.[27]

HAMP Is Based on Mortgagees Acting in Their Own Financial Interest

Lawsuits invoking HAMP sometimes begin on the mistaken premise that a lawsuit is necessary to force the bank or other mortgagee to comply with new government regulations that some envision as providing special protections to homeowners. But HAMP was deliberately designed to create loan modifications only where the mortgagee already has a profit motive for doing so. HAMP achieves this by the NPV test, which is designed to evaluate whether foreclosure or modification would be more profitable.[28] Thus, the cases noted below are largely being brought to try to compel loan servicers to do what their economic incentives would in any event already dictate.[29]

Lawsuits Based on HAMP

Borrowers Lack Standing to Sue Under HAMP

To date, courts have universally dismissed lawsuits brought by borrowers alleging that their loan servicers violated the HAMP guidelines, i.e., that the servicer

25. Sheree R. Curry, *Sue Your Lender, Save Your Home*, Aol Housing Watch (Mar. 16, 2010), http://www.housingwatch.com/2010/03/16/sue-your-lender-save-your-home/11. The Housewife ultimately received a non-HAMP loan modification from her lender. *Id*.

26. *See* Servicer Manual, *supra* note 13, at 18.

27. *See*, *e.g.*, SD 09-01, *supra* note 9, at 5–8 (describing the documentation requirements). Later Supplemental Directives provide more detail about what documents are needed in specific cases, and the Servicer Manual provides the greatest detail. *See* Servicer Manual, *supra* note 13, at 31–33.

28. Servicer Manual, *supra* note 13, at 43–46.

29. Indeed, some members of Congress lamented that this design aspect is not tough enough on the mortgagee:

> The central flaw of [the legislation] is that there are no stronger protections for homeowners and no changes in the language to ensure that the [Treasury] secretary has the authority to compel mortgage servicers to modify the terms of mortgages . . . . We could have demanded language in the legislation that would have empowered the Treasury to compel mortgage servicers to rework the terms of mortgage loans so homeowners could avoid foreclosure.

154 Cong. Rec. H10766 (daily ed. Oct. 3, 2008) (statement of Rep. Dennis Kucinich, D-OH).

failed to modify an eligible loan, or failed to follow the procedural guidelines about the timing of loan modification offers, the order of the waterfall, the use of a forbidden variable in the NPV test, or a similar requirement. Courts have dismissed these cases on two bases.

First, HAMP creates no private right of action; only the government is empowered to enforce its provisions.[30] Thus, even where borrowers allege a material violation of the HAMP guidelines, those violations are not actionable by borrowers.[31]

Second, courts have rejected the borrowers' theory that they are intended third-party beneficiaries of the SPA entered into between loan servicers and the federal government.[32] These courts have concluded that borrowers "generally are assumed to be incidental beneficiaries, rather than intended beneficiaries," of government contracts.[33] Further, the HAMP contracts do not specifically identify borrowers as third-party beneficiaries, and even if they did, a demonstration that the contract benefits the borrowers directly would not be sufficient to confer standing.[34] Of greater significance, the HAMP contracts do not mandate that eligible loans be modified, and thus, even the government cannot sue under the circumstances usually presented by borrowers.[35] Finally, as one court noted, "the breadth and indefiniteness of a class of beneficiaries" tends to negate any inference of intended beneficiary status.[36]

Borrowers Lack Standing to Stop Foreclosures Based on HAMP Guidelines

HAMP-based claims sometimes arise in the context of contested foreclosures. In these suits, borrowers may allege they had a HAMP application pending review, or were placed into a HAMP TPP, but their servicer attempted to foreclose anyway.[37] The HAMP guidelines explicitly require foreclosure sales to be postponed once a

30. *See, e.g.*, Adams v. U.S. Bank, No. 10-10567, 2010 WL 2670702, at *4 (E.D. Mich. July 1, 2010); Hoffman v. Bank of Am., N.A., No. C 10-2171 SI, 2010 WL 2635773, at *5 (N.D. Cal. June 30, 2010); Zendejas v. GMAC Wholesale Mortg. Corp., No. 1:10-CV-00184 OWW GSA, 2010 WL 2629899, at *4 (E.D. Cal. June 29, 2010); Simmons v. Countrywide Home Loans, Inc., No. 09cv1245 JAH(JMA), 2010 WL 2635220, at *5 (S.D. Cal. June 29, 2010); Simon v. Bank of Am., N.A., No. 10-cv-00300-GMN-LRL, 2010 WL 2609436, at *10 (D. Nev. June 23, 2010); Marks v. Bank of Am., N.A., No. 03:10-cv-08039-PHX-JAT, 2010 WL 2572988, at *5–7 (D. Ariz. June 22, 2010).

31. *See, e.g.*, *Simon*, 2010 WL 2609436, at *13 ("[I]t is undisputed that Defendants have an obligation to follow [HAMP] guidelines, but as discussed above, borrowers do not have standing to challenge Defendants' compliance.").

32. *See, e.g.*, *Marks*, 2010 WL 2572988, at *4–5. Courts generally discuss both lack of a private right and third-party beneficiary principles in dismissing HAMP claims. *See* cases cited at *supra* note 30.

33. Villa v. Wells Fargo Bank, N.A., No. 10-CV-81 DMS (WVG), 2010 WL 935680, at *2 (S.D. Cal. Mar. 15, 2010).

34. *Id.* (quoting Cnty. of Santa Clara v. Astra USA, Inc., 588 F.3d 1237, 1244 (9th Cir. 2009)).

35. *See* Escobedo v. Countrywide Home Loans, Inc., No. 09-CV-1557 BTM (BLM), 2009 WL 4981618, at *3 (S.D. Cal. Dec. 15, 2009).

36. *Villa*, 2010 WL 935680, at *3 n.1 (quoting *Cnty. of Santa Clara*, 588 F.3d at 1244).

37. *See, e.g.*, *id.* at *1.

HAMP application is pending.[38] However, the courts have held that plaintiffs lack standing to stop a foreclosure sale based on those HAMP guidelines even where a HAMP application has been submitted.[39]

Constitutional Claims

A few plaintiffs have claimed a constitutional right to a loan modification, and at least one such lawsuit has survived dismissal. In *Huxtable v. Geithner*,[40] the borrower asserted that the lender and the federal government jointly violated his constitutional Fifth Amendment right to due process via the creation of HAMP and subsequently conspired to deprive borrowers of their rights under the program. The Fifth Amendment generally does not apply to private parties, such as loan servicers, but in *Huxtable* the borrower argued that HAMP created joint action by the government and the loan servicer.[41] The court agreed that the plaintiffs had stated a claim: "Plaintiffs contend that the government required private lenders to participate [in HAMP] if they have received federal [TARP and stimulus] money, and the private lenders must administer HAMP on the government's behalf. Whether this is correct or not is not an issue that can be determined on the record before the Court."[42]

Huxtable appears to be an anomalous decision. In *Williams v. Geithner*,[43] the court dismissed comparable Fifth Amendment procedural due process claims brought against the government. In *Williams*, the plaintiffs alleged that they were denied a loan modification under the HAMP guidelines as enacted by the government and as applied by their servicer.[44] The plaintiffs claimed that the government HAMP guidelines unconstitutionally failed to provide the borrower any ability to appeal.[45] The court held that HAMP creates no property interest in a loan modification, and thus, there was no Fifth Amendment claim for the denial of a loan modification, or the lack of an appellate procedure: "The [HAMP authorizing] statute does not create an absolute duty on the part of the Secretary to consent to loan modifications."[46]

Alleged Racial Disparities in the Loan Modification Process

In at least three decisions, federal courts have dismissed claims of race discrimination in failing to offer or consider the borrower for a loan modification. In *Wil-*

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38. *See* Servicer Manual, *supra* note 13, at 26–27. Of note, the guidelines require servicers to actively solicit borrowers' participation in HAMP. *Id*. at 21–22. We believe that most servicers now inform all borrowers who are behind on their payments of the existence of HAMP and offer some time, usually thirty days, to send in an application.

39. *See* Hoffman v. Bank of Am., N.A., No. 10-2171 SI, 2010 WL 2635773, at *4–5 (N.D. Cal. June 30, 2010); *Villa*, 2010 WL 935680, at *2–3.

40. No. 09-CV-1846, 2009 WL 5199333 (S.D. Cal. Dec. 23, 2009).

41. *Id*. at *2.

42. *Id*. at *3.

43. No. 09-1959, 2009 WL 3757380 (D. Minn. Nov. 9, 2009).

44. *Id*. at *4.

45. *Id*.

46. *Id*.

lis v. Countrywide Home Loans Servicing, L.P.,[47] the borrower alleged that his loan modification application was treated less favorably than non-minorities' applications. The court noted that the plaintiff had failed to allege how any non-minority applicant got better treatment, and concluded: "Countrywide's eligibility criteria for its loan modification programs . . . appear to have been based on race-neutral criteria, such as payment history, employment status, and whether a borrower had previously participated in a loan modification program."[48]

In *Adams v. U.S. Bank*,[49] the plaintiff alleged that the bank failed to provide her a loan modification due to her race. She claimed the bank offered a HAMP modification as a technical matter but that, in fact, the bank was pretending the HAMP offer did not exist, by, for example, losing or destroying income documents she sent in support of her application.[50] While the complaint appears to have been inartfully drafted, the court interestingly remarked that it did not see how the plaintiff's supposed reliance on the bank's promise to consider her HAMP application could have led to any detriment: "[T]he fact that [the defendant] may have informed Plaintiff that it would consider her for a loan modification and then lost or destroyed her loan modification application does not imply that she suffered injury as a result. Plaintiff already was indebted for the amount of the mortgage."[51]

Similarly, in *Mbaba v. Indymac Federal Bank, F.S.B.*,[52] the court rejected the borrower's conclusory assertions that the bank and its agents set higher interest rates for modifications to minorities and otherwise offered less favorable modification terms, or less often offered modifications, to minority borrowers.[53]

Foreclosures May Move Forward Despite Pending Loan Modification Applications

Several borrowers have asserted that their servicers solicited their application for a loan modification, and that by this solicitation the servicer effectively offered a loan modification.[54] The courts have rejected this argument. In *Anderson v. Fremont Investment & Loan*, for example, the court held that a lender's invitation to the borrower to apply for a loan modification did not justify reliance so as to estop the lender from foreclosing, nor did it prevent the lender from continuing with the foreclosure even after the borrower applied.[55]

47. No. CCB-09-1455, 2009 WL 5206475 (D. Md. Dec. 23, 2009).
48. *Id.* at *8.
49. No. 10-10567, 2010 WL 2670702 (E.D. Mich. July 1, 2010).
50. *Id.* at *3.
51. *Id.* at *4.
52. No. 1:09-CV-01452-OWW-GSA, 2010 WL 424363 (E.D. Cal. Jan. 27, 2010).
53. *Id.* at *5.
54. *See, e.g.*, Anderson v. Fremont Inv. & Loan, No. 287397, 2009 WL 3837359 (Mich. Ct. App. Nov. 17, 2009).
55. *Id.* at *4.

Other borrowers have similarly argued that their servicer's allusions to a possible loan modification should prevent a pending foreclosure. The courts likewise have rejected these arguments, even where the servicer has made seemingly firm promises about a loan modification. For example, in *Rodriguez v. OneWest Bank*,[56] the borrower alleged that the bank promised to postpone a foreclosure sale while evaluating the borrower for a loan modification. After he sent in the application package, the bank proceeded with a non-judicial foreclosure.[57] The court dismissed the borrower's claims for lack of specificity.[58]

Even when more facts are pled, such claims still have failed. In *Kincaid v. Wells Fargo Bank, N.A.*,[59] the borrower similarly alleged a promise not to foreclose while a loan modification application was pending. Even assuming the facts as pled, the court concluded that the allegations could not give rise to a breach of contract claim because the original loan agreements lacked any promise to postpone foreclosure sales during the pendency of a loan modification application.[60] Moreover, there could be no breach of the implied covenant of good faith and fair dealing because the oral promise occurred long after the loan was originated, and thus fell "outside the scope" of the governing contract.[61] Finally, the mortgagee did not owe any fiduciary duty to its borrower that would prevent it from reneging on its gratuitous oral representation.[62]

In a case with perhaps the best possible set of facts for the borrower, the court still dismissed the lawsuit. In *Stevens v. JPMorgan Chase Bank, N.A.*,[63] the borrower alleged he was told by a customer service representative that the servicer could "likely" work out a loan modification in lieu of foreclosure, but the lender ultimately denied the loan modification application.[64] Among other things, the borrower claimed fraud and false advertising on the basis of credible statistics showing that less than 20 percent of loan modification applications reviewed by the defendant were eventually approved.[65] Thus, he argued, the representative's representation of any likelihood of a loan modification was a fraudulent statement and constituted false advertising.[66] However, the court disagreed, dismissing both claims.[67] Absent an explicit guarantee, the court concluded that the borrowers had failed to allege "that the challenged advertising [was] false or misleading to a reasonable consumer."[68]

56. No. CV09-2361-PHX-NVW, 2010 WL 550760 (D. Ariz. Feb. 16, 2010).
57. *Id.* at *1.
58. *Id.* at *2.
59. 2010 WL 2899058 (D. Ariz. July 22, 2010).
60. *Id.* at *2.
61. *Id.* at *3.
62. *Id.* at *4.
63. No. C 09-03116 SI, 2010 WL 329963 (N.D. Cal. Jan. 20, 2010).
64. *Id.* at *1.
65. *Id.* at *5–6.
66. *Id.*
67. *Id.* at *4–7.
68. *Id.* at *5 (quoting Nat'l Council Against Health Fraud, Inc. v. King Bio Pharms., Inc., 133 Cal. Rptr. 2d 207, 213 (Ct. App. 2003)).

The New Frontier: Emerging and Anticipated Loan Modification Litigation

The Investors Strike Back

Investors have not sat idly while mortgage servicers modify (and reduce) their income stream. For example, investors filed suit in *Greenwich Financial Services Distressed Mortgage Fund 3, LLC v. Countrywide Financial Corp*.[69] The investors sued for breach of contract under their pooling and servicing agreement, arguing that under the terms of that agreement, Countrywide, the originator and seller of the loans, was required to repurchase loans at their original value whenever it agreed to loan modifications.[70]

Countrywide removed the case to federal court based on federal question jurisdiction.[71] The court remanded to state court, and the U.S. Court of Appeals for the Second Circuit affirmed.[72] The district court found that this lawsuit, and presumably all similar lawsuits based on pooling and servicing agreements, was a lawsuit that "solely involves a claim . . . that relates to the rights, duties (including fiduciary duties), and obligations relating to or created by or pursuant to any security."[73] Such lawsuits are delineated exceptions to the broad grant of federal jurisdiction under the Class Action Fairness Act.[74] The district court also rejected arguments that federal questions were raised because interpretation of federal law would be necessary for interpreting the agreements; instead, it found that the investors' claims were garden-variety breach of contract theories that required no special analysis of federal law in order to be adjudicated.[75] One suspects more such investor suits, alleging losses arising out of loan modifications (HAMP or otherwise), will work their way through state courts in the next few years.

Traditional ECOA Suits Wearing New Loan Modification Clothing

Several class action lawsuits based on the Equal Credit Opportunity Act ("ECOA") allege that a failure to issue prompt HAMP denial notices constitutes an adverse action.[76] HAMP guidelines require that notice of denial be sent to the borrower within ten business days of the decision.[77] The ECOA does not require

69. 654 F. Supp. 2d 192 (S.D.N.Y. 2009).
70. *Id*. at 194.
71. *Id*.
72. *Id*. at 204; Greenwich Fin. Servs. Distressed Mortg. Fund 3, LLC v. Countrywide Fin. Corp., 603 F.3d 23, 32 (2d Cir. 2010).
73. *Greenwich*, 654 F. Supp. 2d at 195 (quoting 28 U.S.C. § 1332(d)(9)(C)).
74. *Greenwich*, 603 F.3d at 28–31.
75. *Greenwich*, 654 F. Supp. 2d at 201–04.
76. *See, e.g.*, Complaint, Foster v. Am. Home Mortg. Servicing, Inc., No. 10-cv-10008 (E.D. Mich. filed Jan. 4, 2010).
77. HAMP Supplemental Directive 09-08, at 2–4 (Nov. 3, 2009), *available at* https://www.hmpadmin.com/portal/programs/docs/hamp_servicer/sd0908.pdf [hereinafter SD 09-08] (providing model clauses for various denial reasons).

that an adverse action notice be sent to borrowers already in default, or even just delinquent.[78] However, HAMP allows borrowers who are current on their payments to apply for HAMP if they document an imminent risk of default.[79]

Whether or not the ECOA supports this as a matter of statutory analysis, the Federal Reserve Board has now argued that the ECOA requires an adverse action notice within thirty days whenever non-defaulted borrowers are denied under HAMP.[80] This assertion conflicts with other federal regulations that provide that "[a] refusal to extend credit because applicable law prohibits the creditor from extending the credit requested" is not an adverse action under the ECOA.[81] A borrower who fails to qualify for HAMP is presumably one to whom "applicable law" prohibits extensions of credit under the program. Nor is it apparent that any kind of loan modification decision could require ECOA notice.[82] Note, however, that if the ECOA adverse action requirement does apply, a simple letter stating that the application was denied will not be sufficient—the ECOA requires a full description of the reasons for denial.[83] Thus, the model denial letters provided by the Treasury for HAMP rejections arguably would not pass ECOA muster.[84]

Government Lawsuits

At the time of this writing, it is unknown how vigorously the Treasury will attempt to enforce the HAMP guidelines, or what sanctions may be applied. As of this writing, HAMP enforcement by the Treasury has been minimal to nonexistent, but the United States Attorney General's Office has promised to monitor HAMP data closely for racial disparities.[85] One problem with this inquiry is that servicers have little discretion under the HAMP program. The HAMP guidelines, written by the Treasury, presumably incorporate only race-neutral decision-making factors. Under other circumstances, applying objective, race-neutral creditworthiness factors to lending decisions might still create a disparate impact, and lenders have

78. ECOA § 701(d)(6), 15 U.S.C. § 1691(d)(6) (2006); 12 C.F.R. § 202.2(c)(2)(ii) (2010) (no notice required after "any action or forbearance relating to an account taken in connection with inactivity, default, or delinquency as to that account").

79. *See* SD 09-01, *supra* note 9, at 3–4.

80. Letter from Federal Reserve Bank of San Francisco to State Member Banks 1–2 (Dec. 23, 2009) (citing 12 C.F.R. § 202.9), *available at* http://www.frbsf.org/banking/letters/2009/1223a.pdf; *see also* Baucus, Hickey & Blalock, *supra* note 10, at 156–57.

81. 12 C.F.R. § 202.2(c)(2)(iv) (2010).

82. *See* 15 U.S.C. § 1691a(b) (2006) (defining ECOA "applicant" as one who applies for an "extension, renewal, or continuation of credit"). Loan modifications, a mutually agreed *reduction* in credit, do not fit this definition.

83. ECOA § 503, 15 U.S.C. § 1691(d)(3) (2006).

84. *See* SD 09-08, *supra* note 77, at 2–4.

85. In testimony before Congress in April 2010, Assistant Attorney General Thomas Perez promised to evaluate newly collected HAMP data for racial disparities. *See* Press Release, U.S. Dep't of Justice, Assistant Attorney General Thomas E. Perez Testifies Before the House Subcommittee on the Constitution, Civil Rights, and Civil Liberties (Apr. 29, 2010), *available at* http://www.justice.gov/crt/speeches/2010/crt-speech-100429.html.

had to defend against such claims in the past in the origination context.[86] But the detailed HAMP guidelines completely change the analysis. Can plaintiffs seriously argue that servicers are liable for creating a disparate impact by applying HAMP's race-neutral guidelines as part of a federal program? One suspects a federal circuit court of appeals will be called upon to answer that question, or something like it, within the next five years.

States may end up playing some role as well. Already, Ohio's Attorney General has filed a lawsuit against a servicer, claiming inadequate or incompetent customer service in administering HAMP.[87] And in July 2010, the Illinois legislature enacted a statute preventing foreclosure wherever HAMP's guidelines were not followed.[88] It is too early to know how courts will interpret the new Illinois law, but it is reasonable to expect the law to be read narrowly in light of likely federal preemption, in addition to HAMP lacking any private enforcement mechanisms.

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86. *See, e.g.*, Beaulialice v. Fed. Home Loan Mortg. Corp., No. 8:04-CV-2316-T-24-EAJ, 2007 WL 744646, at *4–5 (M.D. Fla. Mar. 6, 2007) (noting that lender could be liable for disparate impact despite using objective, race-neutral creditworthiness factors in lending decisions, but granting lender summary judgment due to the statute of limitations).

87. *See* Complaint, Ohio v. Barclays Capital Real Estate, Inc., No. 09 10136 (Montgomery Cnty. Common Pleas Ct. filed Dec. 16, 2009).

88. 2010 Ill. Pub. Act 096-1245 (July 23, 2010) (HB 5735) (to be codified at 735 ILL. COMP. STAT. 5/15-1508).

Recent Cases Concerning the Treatment of Attorney Debt Collectors Under the FDCPA

*By Laurie A. Lucas, Tomio B. Narita, and Anna-Katrina S. Christakis**

Introduction

It seems that 2010 was the year for revisiting the treatment of attorney debt collectors under the federal Fair Debt Collection Practices Act.[1] In addition to a U.S. Supreme Court ruling on the "bona fide error defense," which directly affects attorney debt collectors, cases discussed in this survey present a complex range of issues related to litigation, including the filing of state court petitions, attorney's fee awards, and state licensing requirements for out-of-state attorney debt collectors attempting to file suit. Cases addressing FDCPA communications also are reviewed.

Jerman and the Bona Fide Error Defense

In only its second FDCPA opinion, the U.S. Supreme Court, in *Jerman v. Carlisle*, McNellie, Rini, Kramer & Ulrich, L.P.A.,[2] addressed the "bona fide error defense" ("BFED"), which immunizes a debt collector if it can show "by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adapted to avoid any such error."[3] In *Jerman*, the Court held that the BFED does not apply to a debt collector's legal errors when interpreting the FDCPA.[4]

* Laurie A. Lucas is an Assistant Professor of Legal Studies at the Spears School of Business, Oklahoma State University. Tomio B. Narita is a partner at Simmonds & Narita LLP in San Francisco and the Vice Chair of the Debt Collection Practices and Bankruptcy Subcommittee of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law. Katrina S. Christakis is a partner at Grady Pilgrim Christakis Bell LLP in Chicago and Chair of the Debt Collection Practices and Bankruptcy Subcommittee of the Committee on Consumer Financial Services of the American Bar Association Section of Business Law.

1. Pub. L. No. 95-109, 91 Stat. 874 (1977) (codified as amended at 15 U.S.C. §§ 1692–1692p (2006)) [hereinafter FDCPA or Act]. The FDCPA was amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. X, § 1089, 124 Stat. 1376, 1955, 2092–93 (2010) (amending the FDCPA throughout by striking references to "Commission" and inserting "Bureau," as well as amending "Definitions" and "Administrative Enforcement" sections).
2. 130 S. Ct. 1605 (2010).
3. FDCPA § 813, 15 U.S.C. § 1692k(c) (2006).
4. *Jerman*, 130 S. Ct. at 1606.

The defendants in *Jerman* had attached a notice to a state court complaint stating that the debt would be assumed valid unless the plaintiff disputed the debt "in writing" within thirty days.[5] The district court held that the notice violated 15 U.S.C. § 1692g(a)(3), but the claim was barred by the BFED, because the wording of the notice was based on the debt collector's mistaken interpretation of the FDCPA.[6] The U.S. Court of Appeals for the Sixth Circuit affirmed the district court, but the Supreme Court reversed.[7]

The Court rejected the argument that Congress had meant to impose FDCPA liability only on debt collectors who know that their conduct is unlawful, instead noting that "ignorance of the law will not excuse any person, either civilly or criminally."[8] The Court further noted that when Congress wants to provide a mistake of law defense, it generally does so explicitly, citing the administrative penalty provisions of the Federal Trade Commission Act ("FTC Act"),[9] which apply only when a debt collector acts with "actual knowledge or knowledge fairly implied on the basis of objective circumstances" that its conduct is prohibited by the Act.[10] Since the BFED does not contain similar language, the Court inferred that Congress intended to allow recovery for an FDCPA violation even when it results from legal error.[11] The Court further noted that when Congress passed the FDCPA nine years after Truth in Lending Act ("TILA"),[12] it copied the statutory language verbatim from TILA's BFED into the FDCPA.[13] Since three federal courts of appeals had interpreted TILA's BFED to extend only to clerical errors during those nine years, the Court found no reason to conclude that Congress disagreed with those interpretations when it passed the FDCPA.[14]

The Court also concluded that Congress wanted the Federal Trade Commission ("FTC") to resolve ambiguities in the Act, noting that 15 U.S.C. § 1692k(e) provides separate protection from liability for "any act done or omitted in good faith in conformity with any advisory opinion of the [FTC]."[15] Debt collectors would have no incentive to consult the FTC if the BFED provided immunity "for good-faith reliance on advice from private counsel."[16]

Finally, the Court rejected the notion that its decision would lead to a "flood of lawsuits" against debt collection attorneys or create "an irreconcilable conflict between an attorney's personal financial interest and her ethical obligation of zeal-

5. *Id.* at 1609.
6. *Id.* at 1609–10.
7. *Id.* at 1608.
8. *Id.* at 1611 (internal quotation omitted).
9. *Id.* at 1612 (citing FTC Act § 5, 15 U.S.C. § 45(m)(1)(A), (C) (2006)).
10. *See* FTC Act § 5, 15 U.S.C. § 45(m)(1)(A), (C).
11. *Jerman*, 130 S. Ct. at 1612.
12. Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C.A. §§ 1601–1667f (West 2009 & Supp. 2010)).
13. *Jerman*, 130 S. Ct. at 1615–16.
14. *Id.* at 1616.
15. *Id.* at 1615 (quoting FDCPA § 813, 15 U.S.C. § 1692k(3) (2006)).
16. *Id.*

ous advocacy on behalf of a client."[17] Instead, the Court noted the following: if an alleged violation is trivial, actual damages likely will be negligible;[18] statutory damages "based on a good-faith error" of law may be reduced;[19] courts have discretion to reduce attorney's fees below the lodestar amount in appropriate circumstances;[20] attorney's fees can be awarded to a defendant if the court finds that a plaintiff brought the case "in bad faith and for purpose of harassment";[21] and, to the extent that the FDCPA tempers zealous advocacy, that is "hardly unique in our law."[22]

The FDCPA's BFED, therefore, requires that debt collectors maintain "procedures" to avoid the error, and the Court observed that a "procedure" is defined as "a series of steps followed in a regular orderly definite way."[23] Since, according to the Court, legal reasoning is not a "mechanical or strictly linear process," the "relevant procedures are ones that help to avoid errors like clerical or factual mistakes."[24]

Attorneys, Litigation, and the FDCPA

While *Jerman* resolved an important issue regarding the BFED, other issues remain for attorney debt collectors subject to the FDCPA. These include issues related to the filing of state court complaints, the calculation and award of attorney's fees, and the licensing of out-of-state debt collectors.

State Court Complaints and the FDCPA

The U.S. Court of Appeals for the Sixth Circuit, in *Hartman v. Great Seneca Financial Corp.*,[25] considered whether an attorney debt collector's exhibit attached to a state court complaint violated 15 U.S.C. §§ 1692e and 1692f. The exhibit resembled a credit card statement, including spaces for "credit limit, credit available, amount past due, statement closing date, and a summary of transactions."[26] State law required including "a copy of the account or written instrument" evidencing a "claim or defense" to the pleadings.[27] The court held that whether the least-sophisticated consumer would be misled by the exhibit raised a fact question,

17. *Id*. at 1620.
18. *Id*. at 1620–21.
19. *Id*. at 1621.
20. *Id*. at 1621 n.16.
21. *Id*. at 1621.
22. *Id*. at 1622.
23. *Id*. at 1614 (quoting Webster's Third New International Dictionary 1807 (1976)).
24. *Id*.
25. 569 F.3d 606 (6th Cir. 2009).
26. *Id*. at 610.
27. *Id*. at 612 (citing Ohio Civ. R. 10(D)). The Sixth Circuit previously held that it was a false and misleading representation to refer to a claim as "money loaned" rather than as an "account" in an attempt to avoid these state law requirements. *See* Miller v. Javitch, Block & Rathbone, 561 F.3d 588, 592 (6th Cir. 2009).

and reversed summary judgment for the defendants.[28] The *Hartman* court also held that the defendants had not met the BFED's requirements,[29] and rejected the defendants' various arguments about the constitutionality of the FDCPA.[30]

The plaintiff in *Donohue v. Quick Collect, Inc.*[31] also alleged that the attorney debt collector violated §§ 1692e and 1692f by serving her with a state court complaint, but here the issue turned on the claims in the pleadings and not an exhibit.[32] In *Donohue*, the U.S. Court of Appeals for the Ninth Circuit joined the Sixth Circuit[33] and the Seventh Circuit[34] in holding that a false and misleading statement does *not* violate § 1692e unless the statement is "material," and further extended the materiality requirement to include § 1692f violations alleging "unfair or unconscionable means" in the collection of a debt.[35]

The plaintiff in *Donohue* alleged that the debt collector violated the Act by serving her with a state court complaint seeking a sum that was technically incorrect.[36] Despite this, the Ninth Circuit ruled that the complaint did not violate the FDCPA, since the complainant was legally entitled to the sum despite the technical error.[37] The Ninth Circuit further noted that "immaterial statements, by definition, do not affect a consumer's ability to make intelligent decisions," and "we are not concerned with mere technical falsehoods that mislead no one, but instead with genuinely misleading statements that may frustrate a consumer's ability to intelligently choose his or her response."[38]

Finally, in *Ellis v. Solomon & Solomon, P.C.*,[39] the U.S. Court of Appeals for the Second Circuit affirmed a district court's holding discussed in last year's survey.[40] In *Ellis*, the plaintiff was served in a lawsuit on a credit card debt while there were two weeks remaining in the Act's thirty-day validation period.[41] While FDCPA

28. *Hartman*, 569 F.3d at 613. The FTC recently recommended that states take action to require the inclusion of more information about the debt in state court complaints. Fed. Trade Comm'n, Repairing a Broken System: Protecting Consumers in Debt Collection Litigation and Arbitration iii & 18–19 (2010) [hereinafter Repairing a Broken System].

29. *Hartman*, 569 F.3d at 614–15.

30. *Id.* at 614–17 (reviewing five of these constitutional arguments and declining to certify three others to the state's attorney general).

31. 592 F.3d 1027 (9th Cir. 2010).

32. *Id.* at 1029.

33. *See* Miller v. Javitch, Block & Rathbone, 561 F.3d 588, 595–96 (6th Cir. 2009) (noting the materiality requirement in the context of an alleged § 1692e violation).

34. *See* Hahn v. Triumph P'ships LLC, 557 F.3d 755, 758 (7th Cir. 2009) (noting the materiality requirement in the context of an alleged § 1692e violation); Wahl v. Midland Credit Mgmt., Inc., 556 F.3d 643, 646 (7th Cir. 2009) (noting same).

35. *Donohue*, 592 F.3d at 1033–34.

36. *Id.* at 1033.

37. *Id.*

38. *Id.* at 1034.

39. 591 F.3d 130 (2d Cir. 2010).

40. *See* Anna-Katrina S. Christakis, Tomio B. Narita & Laurie A. Lucas, *FDCPA Update: Keeping Pace in a Changing Consumer Environment*, 65 Bus. Law. 673, 674 n.12 (2010) (in the 2010 *Annual Survey*) (noting Ellis v. Solomon & Solomon, P.C., 599 F. Supp. 2d 298 (D. Conn. 2009)).

41. *Ellis*, 591 F.3d at 133.

amendments specifically clarify that collection activities may continue during the thirty-day validation period,[42] subsequent pleadings must not overshadow the validation notice.[43] The Second Circuit's opinion encourages debt collectors to wait until the thirty-day validation period has run before filing suit.[44] Otherwise, the court stated that the debt collector "must" provide the debtor with an "explanation of the lawsuit's impact" on the rights set out in the validation notice.[45] The court also noted that the "explanation should be set forth in either the validation notice itself, or in a notice provided with the summons and complaint . . . , [but] [t]he best practice is to provide an explanation in both."[46]

Attorney's Fees and the FDCPA

Several cases also considered issues regarding attorney's fees and the FDCPA. In a case of first impression, the U.S. Court of Appeals for the Ninth Circuit, in *Rouse v. Law Offices of Rory Clark*,[47] considered the meaning of the Act's civil liability provisions, which allow "the court [upon finding] that an action under this section was brought in bad faith and for the purpose of harassment . . . [to] award to the defendant attorney's fees reasonable in relation to the work expended and costs."[48] In *Rouse*, the district court had awarded the defendant costs in accord with Rule 54 of the Federal Rules of Civil Procedure ("FRCP"), which allow for costs to the prevailing party unless disallowed by another federal statute or court order.[49] The district court held that the wording of the FDCPA required a finding of bad faith and harassment only in relation to the award of attorney's fees, and the language "work expended and costs" related only to the calculation of that award.[50] The district court therefore reasoned that its award of costs under the FRCP was not disallowed by the FDCPA.[51]

Conversely, the plaintiff-appellant argued that if Congress had intended such a reading, the statute would have stated that "the court may award to the defendant attorney's fees reasonable in relation to the work and costs *expended*."[52] The Ninth Circuit agreed with the plaintiff-appellant, noting that "[c]osts are not part of the traditional methodology of determining the reasonableness of attorneys' fees, and for good reason. . . . The lodestar method is the fundamental starting point in determining a reasonable attorney's fee."[53] The Ninth Circuit also noted that "[t]he

42. *Id.* at 135 (citing Financial Services Regulatory Relief Act of 2006, Pub. L. No. 109-351, § 802(c), 120 Stat. 1966, 2006–07 (codified at 15 U.S.C. § 1692g (2006))).
43. *Id.*
44. *Id.* at 136–37.
45. *Id.* at 137.
46. *Id.*
47. 603 F.3d 699 (9th Cir. 2010).
48. FDCPA § 813, 15 U.S.C. § 1692k(a)(3) (2006).
49. *Rouse*, 603 F.3d at 702 (citing Fed. R. Civ. P. 54(d)).
50. *Id.*
51. *Id.*
52. *Id.* at 704.
53. *Id.* (internal quotations omitted).

FDCPA's remedial purpose is served by interpreting § 1692k(a)(3) as authorizing an award of attorneys' fees *and* costs only upon a finding that plaintiff brought the action in bad faith and for the purpose of harassment."[54]

What actually constitutes a reasonable attorney's fee under the lodestar method was the issue in two cases in the U.S. Court of Appeals for the Seventh Circuit. In *Schlacher v. Law Offices of Phillip J. Rotche & Associates*,[55] the Seventh Circuit upheld the district court's reduction of an attorney's fee award to the plaintiffs' lawyers to an amount mirroring the offers of judgment accepted by the two plaintiffs.[56] The plaintiffs-appellants argued it was an abuse of the district court's discretion to equate the attorney's fee award with the plaintiffs' damage awards.[57] In response, the Seventh Circuit noted that while "there is no rule *requiring* proportionality between damages and attorney's fees, a district court may consider proportionality as one factor in determining a reasonable fee."[58] Here, through a series of referrals and the retention of an FDCPA specialist, the plaintiffs had a total of four lawyers working on what the district court had characterized as a "one-lawyer lawsuit . . . settled within three months of filing and without discovery."[59] The Seventh Circuit also noted that while "efficiency can sometimes be increased through collaboration, . . . overstaffing cases inefficiently is common, and district courts are therefore encouraged to scrutinize fee petitions for duplicative billing when multiple lawyers seek fees."[60]

In *Gastineau v. Wright*,[61] the Seventh Circuit also noted that district courts have "the flexibility to adjust . . . [the lodestar] figure to reflect various factors including the complexity of the legal issues involved, the degree of success obtained, and the public interest advanced by the litigation."[62] In *Gastineau*, the district court had reduced both the lawyer's hourly rate and the hours billed. In affirming the district court's reduction of both, and rejecting the lawyer's argument that this constituted "an impermissible double penalty," the Seventh Circuit agreed that "it was inappropriate that a substantial portion of the hours billed were to compensate . . . [the lawyer] for learning this area of law."[63]

Attorneys and Licensing Requirements for Out-of-State Debt Collectors

The licensing of out-of-state debt collectors also appears to be an emerging FDCPA issue. In *LeBlanc v. Unifund CCR Partners*,[64] the U.S. Court of Appeals for

54. *Id.* at 705 (emphasis added).
55. 574 F.3d 852 (7th Cir. 2009).
56. *Id.* at 855.
57. *Id.* at 857.
58. *Id.*
59. *Id.* at 855.
60. *Id.*
61. 592 F.3d 747 (7th Cir. 2010).
62. *Id.* at 748 (internal quotation omitted).
63. *Id.* at 749.
64. 601 F.3d 1185 (11th Cir. 2010).

the Eleventh Circuit reversed a motion for summary judgment in favor of the plaintiff who had alleged violations of FDCPA §§ 1692e(5) and § 1692f in relation to the collection of a credit card debt, and remanded the case for a jury trial.[65] The collection letter sent to the plaintiff indicated that legal action would be considered after thirty-five days if the debt was not paid.[66] The plaintiff had argued that this statement constituted a threat "to take action that cannot legally be taken"[67] since the debt collector was not licensed as required under Florida law, which the plaintiff had asserted was a necessary prerequisite to bringing litigation.[68] On appeal, the defendants argued that, since the relevant Florida law did not provide for a private right of action, allowing the FDCPA action would create inconsistencies between the two laws.[69] The Eleventh Circuit disagreed.[70]

The relevant inquiry for the Eleventh Circuit was first whether the letter constituted a threat and second whether the threat constituted an action that could not be taken.[71] The court surmised that the least-sophisticated consumer arguably could view the letter as either "informative" or "threatening," and therefore held that the determination was a fact question for a jury.[72] Second, the court considered whether the failure to register was a violation of Florida law, which requires registration from "any person whose business activities in this state involve both collecting or attempting to collect consumer debt from debtors located in this state by means of interstate communication . . . and soliciting consumer debt accounts for collection from creditors who have a business presence in this state."[73] The court found that registration was required because the defendants engaged in interstate debt collection activities, had solicited business within the state,[74] and represented a creditor with a business presence in Florida.[75] The court stated that registering as an out-of-state collector "with the State of Florida before filing a lawsuit is a reasonable condition precedent to filing a claim."[76]

The § 1692f claim also turned on the failure of the debt collector to register, as the plaintiff alleged that the threat of legal action not legally allowed constituted an "*unfair* means" to collect the debt.[77] This claim also was remanded for jury consideration, but the Eleventh Circuit indicated that it seemed "doubtful" that the least-sophisticated consumer would read the letter as unfair or unconscionable.[78]

65. *Id*. at 1188.
66. *Id*.
67. *Id*. at 1193 (citing FDCPA § 807, 15 U.S.C. § 1692e(5) (2006)).
68. *Id*. at 1190 (citing Fla. Stat. § 559.553).
69. *Id*. at 1192.
70. *Id*.
71. The court noted that if a jury decided the letter did not constitute a threat then the second inquiry was mooted. *Id*. at 1197 n.22.
72. *Id*. at 1195–97.
73. *Id*. at 1197 (quoting Fla. Stat. § 559.55(8)).
74. The court expressly rejected the argument that purchasing charged off accounts did *not* constitute "solicitation." *Id*. at 1197–98 & n.25.
75. *Id*. at 1198.
76. *Id*.
77. *Id*. at 1200.
78. *Id*. at 1200 n.31.

The Eleventh Circuit also adopted the least-sophisticated consumer standard for a § 1692f analysis, since "fairness and unconscionability necessarily include inquiry regarding deceptiveness, and because this inquiry is less dependent upon the individual debtor's circumstances than the 'means' employed by the debt collector and the debtor's reaction to said means."[79] Here the "means" was the letter and not the failure to register.[80] Finally, the court held that the BFED could not be heard on appeal, and that the general partners of the debt collector were jointly and severally liable under Florida law.[81]

FDCPA Communications

In *Gburek v. Litton Loan Servicing LP*,[82] the U.S. Court of Appeals for the Seventh Circuit considered whether communications from a loan servicer and that servicer's agent attempting to work out alternatives to foreclosure proceedings with the plaintiff constituted FDCPA "communications."[83] The district court, in a class action lawsuit, previously held in favor of the defendant on a motion to dismiss, stating that because the letters sent to the plaintiff from the loan servicer and its agent did not demand payment for the debt, the FDCPA did not apply.[84] The Seventh Circuit reversed.[85]

Specifically, the Seventh Circuit found that the district court's reading of the statute was too narrow given the totality of the facts, including that the loan at issue was already in default and the letters were therefore meant "to induce her to settle her mortgage-loan debt" in lieu of foreclosure.[86] The court noted that no circuit has a "bright-line rule" for making determinations about when communications constitute FDCPA communications,[87] and, although prior cases had required an explicit demand for payment before finding that the communication triggered the FDCPA protections, the communication in *Gburek* could be distinguished.[88]

First, the Seventh Circuit noted that previous precedent requiring a demand for payment before triggering FDCPA provisions had dealt with communications regarding a forbearance agreement that was not in default; the communication was merely a descriptive communication about the status of the agreement, rather than an attempt to collect a debt.[89] That case, however, as the Seventh Circuit

79. *Id.* at 1201.
80. *Id.* at 1200.
81. *Id.* at 1201–02. The court indicated that whether "partners of a debt collector limited partnership may be held vicariously liable for the partnership's conduct" under the FDCPA was one of first impression in the Eleventh Circuit, but did not issue a ruling, instead finding joint and several liability under Florida law. *Id.*
82. 614 F.3d 380 (7th Cir. 2010).
83. The FDCPA defines "communications" as "the conveying of information regarding a debt directly or indirectly to any person through any medium." FDCPA § 803, 15 U.S.C. § 1692a(2) (2006).
84. *Gburek*, 614 F.3d at 381.
85. *Id.* at 382.
86. *Id.*
87. *Id.* at 384.
88. *Id.* at 383.
89. *Id.* at 384–85 (citing Bailey v. Sec. Nat'l Servicing Corp., 154 F.3d 384, 388–89 (7th Cir. 1998)).

noted, "suggests some limits on the reach of the FDCPA, making it clear that the statute does not apply to *every* communication between a debt collector and a debtor."[90] Second, the court noted that communications intended "to induce the debtor to settle" a debt trigger the Act regardless of whether a specific demand for payment was made.[91] And, last, the court noted that a privacy notice, which did not make a demand for payment but was sent with a dunning letter in an attempt to collect a debt, also triggers the FDCPA.[92] In sum, the court noted that whether a communication triggers the FDCPA is an objective inquiry based on "the purpose and context of the communications."[93]

Finally, in *Gonzalez v. Kay*,[94] the U.S. Court of Appeals for the Fifth Circuit reversed the district court's ruling in favor of the defendants on a motion to dismiss.[95] In *Gonzalez*, the debt collector sent an unsigned letter to the plaintiff using law firm letterhead directing the plaintiff to "see [the] reverse side for important information."[96] On the reverse side, in the same font and typeface, was the following disclaimer: "At this point in time, no attorney with this firm has personally reviewed the particular circumstances of your account."[97] Despite the disclaimer, the plaintiff alleged, among other claims, that this language violated § 1692e(3)'s prohibition on falsely representing that an attorney was involved in the collection of the debt.[98]

The Fifth Circuit reviewed prior precedent with similar but distinguishable facts from the Second,[99] Third,[100] Sixth,[101] and Seventh[102] Circuits, as well as prior precedent in the Fifth Circuit,[103] in which the courts had found violations or the clear possibility of violations when an attorney letterhead was used in communications with the debtor. The *Gonzalez* court, however, also reviewed precedent from the Second Circuit that provided guidance to debt collectors on a disclaimer similar to the one in *Gonzalez*, which the Second Circuit held would *not* mislead an unsophisticated consumer: "At this time, no attorney with this firm has personally

90. *Id.*

91. *Id.* at 385 (citing Horkey v. J.V.D.B. & Assocs., Inc., 333 F.3d 769 (7th Cir. 2003)).

92. *Id.* (citing Ruth v. Triumph P'ships, 577 F.3d 790 (7th Cir. 2009)).

93. *Id.*

94. 577 F.3d 600 (5th Cir. 2009).

95. *Id.* at 601.

96. *Id.* at 602.

97. *Id.*

98. *Id.* at 603.

99. *See* Clomon v. Jackson, 988 F.2d 1314, 1316 (2d Cir. 1993) (finding a violation when letter included a facsimile of an attorney's signature but no attorney involvement).

100. *See* Rosenau v. Unifund Corp., 539 F.3d 218, 223–24 (3d Cir. 2008) (finding that a letter sent from a "Legal Department" suggested attorney involvement and a possible violation of the Act).

101. *See* Kistner v. Law Offices of Michael P. Margelefsky, LLC, 518 F.3d 433, 440–41 (6th Cir. 2008) (holding that whether consumer would be misled by letter on law firm's letterhead that stated it was from a "debt collector" presented a fact question for a jury).

102. *See* Avila v. Rubin, 84 F.3d 222, 229 (7th Cir. 1996) (noting that a collection letter from an "attorney" indicates to the consumer that "the price of poker has just gone up").

103. *See* Taylor v. Perrin, Landry, deLaunay & Durand, 103 F.3d 1232, 1237 (5th Cir. 1997) (finding that a letter that included a facsimile of an attorney's signature and used other language indicating attorney involvement violated the Act).

reviewed the particular circumstances of our account. However, if you fail to contact this office, our client may consider additional remedies to recover the balance due."[104] Despite the similarities between the Second Circuit case and *Gonzalez*, the *Gonzalez* court held that the issue of whether a consumer would be misled by the disclaimer required further consideration by the district court,[105] since "reasonable minds can differ,"[106] and remanded the case.[107] The court also "caution[ed] lawyers who send debt collection letters" to use a conspicuous disclaimer clearly characterizing their role in the process.[108]

Conclusion

The cases reviewed in this year's survey underscore the continued complexity of FDCPA litigation. Changes in the regulatory environment also may add another level of uncertainty for debt collectors. The FTC recently entered into a $1 million settlement with Credit Bureau Collection Services based on charges that the company violated the FDCPA, among other laws.[109] At the state level, the Attorney General of Minnesota filed suit against the National Arbitration Forum ("NAF") for alleged abuses in debt collection arbitration, resulting in the cessation of debt collection arbitration by NAF.[110] The FTC also reported that the American Arbitration Association has instituted a moratorium on debt collection arbitration.[111] Finally, although the Dodd-Frank Act contains an exclusion for attorneys engaged in the practice of law, that exclusion does not limit the authority of the Bureau of Consumer Financial Protection ("CFPB") over attorneys subject to certain consumer laws, including the FDCPA.[112] Any debt collection attorney who is subject to the FDCPA will need to comply with the new law, as well as any regulations, if any, ultimately issued by the CFPB.

104. *Gonzalez*, 577 F.2d at 605 (quoting Greco v. Trauner, Cohen & Thomas, L.L.P., 412 F.3d 360, 361 (2d Cir. 2005)).

105. *Id.* at 606. The dissent argued that the issue was more appropriately decided as a matter of law. *Id.* at 611–12 (Jolly, J., dissenting).

106. *Id.* at 607 (majority opinion).

107. *Id.*

108. *Id.*

109. *See* U.S. v. Credit Bureau Collection Servs., Inc., No. 2:10-CV-169 (S.D. Ohio Feb. 24, 2010) (consent decree), *available at* http://www.ftc.gov/os/caselist/0623226/100303creditcollectiondecree.pdf.

110. *See* Repairing a Broken System, *supra* note 28, at ii & 39–40.

111. *Id.*

112. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. X, § 1027(e)(3), 124 Stat. 1376, 1955, 1999 (2010) (to be codified at 12 U.S.C. § 5517(e)(3)) (removing the "Exclusion for Practice of Law" exemption for attorneys otherwise subject to consumer laws enumerated in the Dodd-Frank Act, including the FDCPA); *see also* Julie R. Caggiano, Jennifer L. Dozier, Richard P. Hackett & Arthur B. Axelson, *Mortgage Lending Developments: A New Federal Regulator and Mortgage Reform Under the Dodd-Frank Act*, 66 Bus. Law. 457, 460 n.32 (2011) (in this *Annual Survey*) (noting Dodd-Frank Act § 1002(15)(A)(x)).

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