

Financial Services Litigation

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NEWSWIRE

The SEC Suit Against Goldman Sachs

By Thomas J. Hall and Keith Levenberg

In a widely publicized matter, on April 16, 2010 the Securities and Exchange Commission filed a civil enforcement action in United States District Court for the Southern District of New York against Goldman Sachs & Co. ("GS") and GS employee Fabrice Tourre. The com-

IN THIS ISSUE

- 1 The SEC Suit Against Goldman Sachs
- 3 Lender Liable for Trespass Amidst Foreclosure Action
- 6 Claims Dismissed Against Hedge Fund Auditors Over Failure to Uncover Madoff Scheme
- 7 Loan Insurers Lack Third-Party Beneficiary Standing to Bring Claims Under Loan Sales Agreements
- 9 Court Imposes Punitive Damages on Lender for Failing to Negotiate Loan Modification in Good Faith
- 12 Lender Has No Duty to Act in Good Faith Under Demand Note
- 13 Wachovia Agrees to Record Penalties for Lack of Effective Anti-Money Laundering Compliance Programs
- 15 E-mail Confirmations of Credit Card Transactions Not Covered by Fair and Accurate Credit Transaction Act
- 16 Court Dismisses Claim That Lender Improperly Disbursed Construction Loan Proceeds
- 18 National Bank Act Preempts State Law on Customer Fees
- 19 Court Dismisses Securities Fraud Claims Against Canadian Imperial Bank of Commerce
- 21 Identities of Banks Borrowing at Discount Window Not Exempt from FOIA Requests
- 24 Wells Fargo Sanctioned for Failing to Mediate in Good Faith
- 27 FINRA and NASD Entitled to Absolute Immunity

plaint, which asserts claims under § 17(a) of the Securities Act and § 10(b) of the Securities Exchange Act, arises out of one particular synthetic collateralized debt obligation ("CDO") marketed by GS in early 2007. Called "ABACUS 2007-AC1," the CDO was tied to the performance of various subprime residential mortgage-backed securities. The opening paragraph of the complaint alleges that "[s]ynthetic CDOs like ABACUS 2007-AC1 contributed to the recent financial crisis by magnifying losses associated with the downturn in the United States housing market." The complaint seeks civil monetary penalties, disgorgement of profits, and unspecified injunctive relief.

The SEC's Allegations

The complaint alleges that GS created the CDO in response to investment-management firm Paulson & Co.'s expression of interest in potential transactions in which it could take a short position in mortgage-backed securities that it believed would experience significant losses. Paulson based its strategy on its view that "the market is not pricing the subprime RMBS [residential mortgage-backed securities] wipeout scenario." Indeed, the firm's funds would go on to record profits in 2008 when that scenario materialized. But in early 2007, many investors were still confidently buying derivatives tied to subprime mortgages.

The complaint alleges that GS and Tourre (then a Vice-President on GS's structured product correlation trading desk) "knew that it would be difficult, if not impossible," to market the CDO "if they disclosed to investors that a short investor, */ continued page 2*

Goldman Sachs

continued from page 1

such as Paulson, played a significant role in the collateral selection process,” and “therefore sought a collateral manager to play a role in the transaction proposed by Paulson.” ACA Management LLC, an experienced CDO manager with 22 CDOs worth over \$15 billion under its belt, was retained to serve as the Portfolio Selection Agent for the ABACUS 2007-AC1 CDO.

On January 9, 2007, GS allegedly provided to ACA a list of 123 mortgage-backed securities Paulson proposed to include in the portfolio. ACA countered with its own proposed list of 86 securities, including 31 of its own selections and 55 from Paulson’s list. On February 2, after a series of meetings with GS, ACA, and Paulson, ACA circulated a list of 82 securities approved by both Paulson and ACA and 21 additional propos-

The primary alleged misrepresentations fall into two categories. First, the SEC alleges that GS misled ACA into believing that Paulson was investing in ABACUS 2007-AC1, when in fact Paulson intended to take a short position. The complaint suggests that ACA would not have served as Portfolio Selection Agent, and “would have been reluctant” to give Paulson a role in the portfolio selection, had it known Paulson intended to take a short position. (Notably, Paulson denies that ACA was unaware of its position.) Second, the complaint alleges that investors were not informed that Paulson or any party with interests averse to investors had participated in the collateral-selection process.

The Causes of Action

Securities Exchange Act § 10(b), and the SEC’s Rule 10b-5 promulgated thereunder, make it unlawful for anyone to make

The SEC’s posture can thus be expected to lead to a commensurate increase in private securities litigation, initiated either by investors in their individual capacities or by putative classes attributing stock-price declines to misrepresentations about mortgage-backed securities.

als. According to the complaint, Paulson rejected 8 of the additional proposed securities, including all the ones based on mortgages written by a bank “generally perceived as one of the higher-quality subprime loan originators,” and by February 26 the parties had agreed on a reference portfolio of 90 securities to include in the CDO. GS proceeded to market the CDO to investors, one of which is alleged to have lost the majority of its \$150 million investment. The other big loser allegedly was ABN AMRO Bank N.V., which entered into a series of credit default swaps with GS and ACA in which it assumed the credit risk associated with a portion of the ABACUS 2007-AC1’s capital structure in exchange for premium payments of approximately 17 points per annum. ABN eventually unwound its position by paying GS \$841 million, most of which GS paid out to Paulson.

any untrue statement of material fact, or omit to state any fact necessary to make other statements not misleading, in connection with the purchase or sale of a security. Securities Act § 17(a) prohibits substantially the same conduct but lacks a private right of action, limiting § 17(a) claims to actions brought by the government.

Potential Defenses

GS will likely take advantage of the usual stable of securities defenses. For one, the complaint is notably short of particularity on precisely what misstatements “misled” ACA into believing that Paulson was long on the CDO. No statements by GS and Tourre suggesting as much are cited in the complaint; instead, the complaint cites an ACA e-mail eventually forwarded to Tourre referring to “Paulson’s equity perspective” as

something that should have put Toure on notice, or rendered him “reckless in not knowing,” that ACA believed Paulson was investing in the CDO.

In addition, GS can be expected to argue that the alleged omissions were immaterial as a matter of law. Notably, the SEC does not allege that any *facts* about the underlying securities were misrepresented. Rather, the complaint only alleges that purchasers of the securities were unaware that Paulson was taking a short position — *i.e.*, that Paulson had formed a different *opinion* about the investment potential of the securities than ACA did, given exactly the same facts and the same opportunity to study and analyze them. In other contexts under the securities laws, an “undisclosed motivation” for a securities transaction generally does not give rise to a claim of material misstatement absent objectively false or misleading statements about the underlying subject matter. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) (concerning § 14(a) proxy-disclosure claims). Furthermore, statements of opinion are generally held not actionable under the securities laws unless they are shown to be both subjectively and objectively false — *i.e.*, both (i) that the person did not actually hold the opinion attributed to him *and* (ii) that the statement of opinion misrepresented objective facts.

Implications

The case’s significance lies primarily in what it augurs for future enforcement proceedings and the prospect of related private litigation.

One wire service speculated that “[t]he case suggests that a reinvigorated SEC, after a long lull, is pressing to hold Wall Street accountable for its role in the worst financial crisis since the Great Depression.” Former SEC attorney and Boston University law professor Elizabeth Nowicki reportedly told the press, “The SEC wanted to convey the message that no, they’re not sitting back on their heels. . . . You can’t really go after anybody bigger than [GS].” If commentators are correct that the agency wishes to be seen as active in prosecuting bankers for risks that contributed to the 2008-2009 recession, we can expect that future enforcement actions will focus not merely on the largest banks but on others involved in marketing CDOs, CDSs, and other instruments blamed for magnifying subprime mortgage-related losses.

It is also notable that the actual alleged victims of the alleged fraud have not themselves asserted any securities claims, arising out of the allegations of the SEC complaint at this time. If SEC enforcement actions gain traction, parties

that actually experienced losses arising from mortgage-backed securities may find the climate hospitable for private securities claims of their own against counterparties, underwriters, and anyone else that can be blamed for their losses.

The SEC’s posture can thus be expected to lead to a commensurate increase in private securities litigation, initiated either by investors in their individual capacities or by putative classes attributing stock-price declines to misrepresentations about mortgage-backed securities. According to one study, in recent years, the size of the average settlements in private suits with parallel SEC cases are more than triple those where there is a private class action alone. The securities plaintiffs’ bar can thus be expected to take advantage of the SEC’s enforcement actions to develop facts to support their own class-action claims and exert greater leverage in settlement negotiations.

Several shareholder suits have already been filed against GS claiming that the course of conduct alleged in the SEC complaint led to investment losses in GS stock. The complaints focus on the decline in GS’s stock price after the SEC filed its suit and allege that GS should have disclosed both its alleged conduct relating to the ABACUS transaction and the 2009 Wells notice informing GS of the SEC’s investigation. An analyst report by Credit Suisse projected that GS and other banks can expect their litigation costs from private suits to exceed the amount they will spend defending themselves in suits brought by regulators.

On May 7, the *Wall Street Journal* reported that GS had entered into preliminary settlement discussions with the SEC. While an early settlement may limit the ability of private plaintiffs to exploit the information revealed in the SEC action to develop their own claims against GS, it would also seem likely to embolden litigants pursuing similarly theorized claims not only against GS but also any other institutions involved in marketing mortgage-based derivatives. ©

Lender Liable for Trespass Amidst Foreclosure Action

By Laura Rowntree

In a dispute not often seen in foreclosure litigation, a New York state judge imposed consequential and punitive damages on Wells Fargo for improper entry into / *continued page 4*

Wells Fargo

continued from page 3

a home the bank considered abandoned. *Wells Fargo v. Tyson*, 2010 WL 753360 (Suffolk Co. March 5, 2010). Steven Tyson, the defendant in the underlying foreclosure proceeding, notified the court that the bank had entered his home and changed the locks without notice. Despite Wells Fargo's contention that it had done so to secure the property, a claim the court deemed "specious," Justice Jeffrey A. Spinner ordered the bank to pay Tyson \$200 for the trespass, nearly \$5,000 for lost property, and \$150,000 to "serve as an appropriate deterrent to any future outrageous, improper and unlawful deeds."

A Problematic History

Wells Fargo was the assignee of a mortgage against Tyson's home in Greenlawn, New York. In September 2007, Wells

agent entered the home and changed the locks, thereby preventing Tyson from gaining access. According to Tyson, the bank initially denied knowledge of the incident and then referred him to its legal counsel, which indicated that it had inspected and secured the property pursuant to its standard procedure. Tyson testified that the bank gave its assurances that it would not enter the property again and was initially apologetic about its actions, including, Tyson claimed, the drilling out of his door lock cylinders.

About a month after the bank's initial entry, in late December or early January, Tyson allegedly received a phone call from a neighbor who notified him that a group had entered the property. Tyson confronted the individuals who, he learned, had gained entry using the same key that the bank had provided to him after changing his locks the previous month. Tyson urged the bank's agents to leave the prop-

As a result of the bank's "shockingly wrongful conduct," and "to serve as an appropriate deterrent to any future outrageous, improper and unlawful deeds," the court ordered Wells Fargo to pay \$150,000.

Fargo commenced a proceeding to foreclose on that property, and was pursuing the proceeding actively through the end of 2009. By November 2009, Tyson and his family had moved out of the property because their financial condition made maintenance expenses, particularly the high utility costs, unmanageable. At a February 2010 hearing to address the trespass allegations, Tyson testified that, although he resided elsewhere, he visited the property at least once a week and kept most of his belongings there. Additionally, he testified about the many steps he had taken to maintain the home while vacant, including efforts to winterize the heating and plumbing systems. Tyson also testified that he had notified Wells Fargo that he was living elsewhere, had discontinued utility services, and had secured the home.

The parties did not dispute that, in November 2009, Wells Fargo, without notice, sent an agent to the property. The

erty and not return. Tyson returned the following day to find his garage open and a variety of household items missing, which he valued at \$4,892. Tyson contacted the local police and later the court, prompting the February hearing to resolve the dispute.

At the hearing, Wells Fargo presented testimony from a third-party contractor whose private property inspection and preservation firm was directed to inspect the property on November 3, 2009. The witness initially testified that he discovered "the front door . . . wide open and the premises completely unsecured," of which he notified the bank. He testified that his company did indeed change the locks, but claimed it did so by unscrewing the existing locks from the open door rather than by forcibly drilling them out of the door as Tyson contended. However, "after a rather probing examination by the court," the witness "conceded he had no actual knowledge

as to the matters about which he testified,” having never visited the property personally. In response to this concession, the court deemed the testimony to constitute inadmissible hearsay. Moreover, the court noted that the bank did not otherwise deny the actions Tyson attributed to it. Rather, the court described counsel for Wells Fargo as “doggedly insist[ing] that [the bank] was wholly justified” in entering the home and protecting the property as it deemed appropriate.

A Question of Trespass or Securing the Property

As a preliminary matter, the court addressed the terms of the mortgage agreement, which permitted Wells Fargo to enter the property under certain circumstances. First, the agreement allowed the bank to enter and inspect the property “in a reasonable manner and at reasonable times.” However, that provision required that the bank provide notice of any need for an interior inspection before it, or its agent, could enter the property. The bank failed, or declined, to establish that it had provided notice to Tyson, arguing only that it possessed the right to enter the property. Accordingly, the court determined the bank had “breached its own contract” by failing to provide notice.

As a second and alternative ground for the bank’s entry, the court considered the provision of the mortgage agreement that permitted entry in the case of abandonment. Under that provision, if the mortgagor should abandon the property, the lender “may do and pay for whatever is reasonable and appropriate to protect [its] interest in the Property.” The agreement enumerated several permitted actions including “protecting and/or assessing the value of the property [and] securing and/or repairing the property,” in addition to entering to make repairs or change the locks. The court interpreted this provision to establish abandonment as a condition precedent to entry. Crediting Tyson’s testimony and dismissing that of the bank’s agent, the court held that Tyson had not abandoned the property, rejecting the bank’s justification for entry. In any event, the court cited New York law for the proposition that, as a contract of adhesion, a mortgage agreement should be read against the drafter, here the bank.

The court applied the elemental definition of trespass and characterized the bank’s action as an intentional entry without permission or legal authority, which compromised Tyson’s right of exclusive possession. Under the basic trespass theories cited by the court, a trespasser must act with specific intent, either to enter the land or to engage in an act certain to lead to entry. The entry need not be malicious, and liability

can be appropriate where a trespasser entered a property under an erroneous belief that he has the right to enter. Likewise, trespass can lie against a party at whose direction a third party has entered a property unlawfully. The court applied these principles to the circumstances surrounding Wells Fargo’s entry to find that a trespass, attributed to the bank, had occurred on two separate occasions and that a determination of liability was appropriate.

Recovery and Damages

The court ordered Wells Fargo to compensate Tyson by way of actual and punitive damages. Initially, the court noted that actual damages are not mandatory to establish a trespass claim, but that nominal damages are appropriate in actions where damage is *de minimis* or not readily quantifiable. A party injured by trespass, like Tyson, may nevertheless recover for all consequences of the trespass, including damage to property and injury to the person, but only to the extent that such damages arise as a direct result of the trespasser’s wrongful intrusion. Generally, the calculation of actual damages is the lesser amount of either the decline in fair market value caused by the trespass or the cost of restoring the property to the prior state.

In the case of Wells Fargo’s trespass, the court noted that there was no evidence to indicate the home’s value was diminished in any way by the bank’s conduct. Accordingly, the court determined the appropriate measure of damages to be the nominal amount of \$200. However, the court ruled that Tyson was entitled to recover \$4,892 for the value of the personal property that went missing after the final act of trespass.

Despite its relatively modest award of actual damages, the court here was keen to impose punitive damages, which are deemed necessary to effectuate punishment and to deter any future misconduct. As an action to foreclose a mortgage is an equitable proceeding, the court applied the rules of equity to invoke the power “to do that which ought to be done.” In awarding punitive damages, the court cited the two separate instances of improper entry by the bank’s agent, which it deemed “willful and . . . calculated and . . . not accidental in any way.” It also underscored Tyson’s affirmative notice to the bank that he had not abandoned his property. As a result of the bank’s “shockingly wrongful conduct,” and “to serve as an appropriate deterrent to any future outrageous, improper and unlawful deeds,” the court ordered Wells Fargo to pay \$150,000. ©

Claims Dismissed Against Hedge Fund Auditors Over Failure to Uncover Madoff Scheme

By Robert A. Schwinger and Christopher Cusmano

In a March 30, 2010 decision, Judge Thomas P. Griesa of the United States District Court for the Southern District of New York granted a motion to dismiss claims against two accounting firms, KPMG LLP and Ernst & Young LLP, as part of a putative class action arising from the fraudulent Ponzi scheme orchestrated by Bernard L. Madoff. The claims were brought by investors in three hedge funds whose assets were managed by Bernard L. Madoff Securities LLC. The accounting firms served as the auditors for those three hedge funds. The investors claimed that the hedge funds auditors misled the investors into believing that the auditors were diligently auditing the funds which, if done, would have caused them to uncover Madoff's fraud. *In re Tremont Securities Law, State Law and Insurance Litigation*, No. 08 Civ. 11212 (TPG) (S.D.N.Y. March 30, 2010).

The Investors' Claims

The claims arose in connection with failed investments made by three hedge funds with Bernard L. Madoff and his investment firm, Bernard L. Madoff Securities LLC. The plaintiffs were investors in those hedge funds, which were managed by Tremont Partners under an agreement that authorized Tremont to delegate management of the funds' assets to a single manager. Tremont selected Madoff and his firm to be the funds' exclusive manager, and after Madoff's Ponzi scheme was uncovered in late 2008 the plaintiffs allegedly lost their investments.

As part of a larger class action complaint filed against multiple defendants, including Tremont Partners and the funds' directors, the plaintiffs alleged that the accounting firms failed to detect Madoff's fraud when they performed annual audits of the funds. The plaintiff's claim against the auditors was based on Section 10(b) of the Exchange Act, which prohibits deceptive or manipulative conduct intended to mislead investors. In a somewhat novel approach, the plaintiffs alleged they were misled by the defendants because the accounting firms failed to diligently perform their annual

audits of the funds. Although the plaintiffs conceded that the auditors were engaged only to audit the funds', and not Madoff's, financial statements, the complaint asserted that because Madoff managed the hedge funds' investors, the auditors should have gathered independent evidence of Madoff's assets and trading activity pursuant to Generally Accepted Auditing Standards (GAAS). Had the auditors attempted to gather this evidence, the plaintiffs alleged, they would have uncovered Madoff's fraud and the investors could have been notified before their investments were lost.

Pleading Requirements

In asserting a claim under Section 10(b) of the Exchange Act, a plaintiff must comply with the heightened pleading requirements of Section 101(b) of the Private Securities Litigation Reform Act. The complaint must allege facts that show the defendant made a false representation, or omitted to disclose material information the defendant was under a duty to disclose, in connection with the sale or purchase of securities, with scienter, upon which plaintiff reasonably relied and that plaintiff's reliance was the proximate cause of injury. The allegation must be made with particularity and create a strong inference that the defendant acted with the requisite state of mind, namely, to deceive, manipulate or defraud the plaintiff. This scienter requirement is sufficiently pled either by demonstrating that the defendant had both the motive and opportunity to commit fraud, or by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. The court noted, however, that if a complaint relies on an inference of scienter, the court must also consider any competing inference that may be rationally drawn from all of the alleged facts when taken together.

The Dismissal of the Claims

The defendant auditors filed a motion to dismiss the claims against them, arguing that the complaint failed to satisfy these heightened pleading requirements as there were no specific allegations of scienter, noting that the complaint failed to allege that the auditors knew of Madoff's fraud before it was uncovered in 2008. Instead, the plaintiffs effectively asserted that the audits were so reckless that one could infer that the auditors acted with the required state of mind to deceive, manipulate or defraud the investors.

Emphasizing that the standard for pleading auditor scienter is demanding, the court rejected plaintiff's argument and dismissed the claims as against the accounting firms. As

there were no specific allegations that the auditors were aware of the fraud at any time, the court found the plaintiffs' inference of scienter was lacking. To establish recklessness in this context, the court noted, the plaintiff cannot merely allege a violation of GAAS — the complaint must allege conduct that is highly unreasonable and an extreme departure from the standards of ordinary care. Essentially, the accounting practices must have been so deficient that the audit amounted to “no audit at all.” The court explained that this threshold may be met by alleging that the auditor disregarded specific “red flags” that would place a reasonable auditor on notice that the company was engaged in wrongdoing. The court found that simply alleging that the defendants could have audited Madoff as the fund manager and that such an audit might have led to the discovery of fraud was insufficient. The audit must have been so poor that it would approximate an actual intent to aid in the fraud being perpetrated by the audited company. In the complaint, however, there was no such allegation.

In dismissing the complaint, the court took the position that it was not plausible that the auditors had participated in Madoff's fraud by virtue of failing to detect it while performing audits of the funds. Even assuming that the “red flags” alleged by the plaintiffs did exist at the time of the audit, there was nothing to demonstrate that the auditors knew of these facts and ignored them. For example, the court noted that the auditors were not aware of the letter sent by an SEC staffer to his supervisors ten years earlier warning of fraud, that Madoff's returns could not be replicated by others, or that some investors in the funds had decided to avoid future involvement with Madoff.

Rather than accepting the complaint's proposed inference that the auditors did not discover fraud because they failed to comply with GAAS, the court emphasized that the more compelling inference as to why Madoff's fraud went undetected was his proficiency in covering up the scheme and eluding the SEC and other financial professionals. Even more important to the court, however, was the fact that the auditors were never engaged to audit Madoff's firm or to issue an opinion on any financial statements from Madoff or his firm. The court found no basis for the plaintiff's notion that an accounting firm hired to audit an individual fund must also conduct audit procedures on a non-client third party simply because he manages the fund. As the court concluded, “to impose liability on the Auditors would expand their limited, circumscribed duty impermissibly.”

Loan Insurers Lack Third-Party Beneficiary Standing to Bring Claims Under Loan Sales Agreements

By Thomas J. Hall and Maureen K. Schad

In a recent decision that could have significant impact on litigation arising from the recent mortgage crisis, a New York court dismissed the claims of two bond insurers who sued the loan originator for allegedly misrepresenting the values of the loans securing the bonds and otherwise for violating underwriting guidelines. In *U.S. Bank Nat'l Ass'n v. GreenPoint Mortgage Funding, Inc.*, No. 600352/09 (N.Y. Co. Mar. 3, 2010), Justice Bernard J. Fried of the New York Supreme Court held that the loan insurers did not have standing to bring such claims, as they were not parties to the initial sales agreement and they had failed to establish that they were intended third-party beneficiaries thereof.

Background

GreenPoint Mortgage Funding, Inc. (“GreenPoint”) allegedly originated over 30,000 home equity lines of credit and home mortgage loans which it sold to GMAC Mortgage Corporation (“GMAC”) pursuant to two sales agreements (“Sale Agreements”). GMAC resold those mortgage loans to Lehman Brothers Bank, F.S.B., which assigned them to Lehman Brothers Holding, which later assigned them to Structured Assets Securities Corporation (“SASCO”). SASCO deposited the loans into a Trust (“Trust”), where they were used to secure the issuance of mortgage-backed bonds. U.S. Bank, one of the plaintiffs in the suit, was the Indenture Trustee of that Trust. Syncora Guarantee Inc. (“Syncora”) and CIFG Assurance North America, Inc. (“CIFG”) (the “Insurers”) insured that pool of mortgage loans in the Trust that securitized the bonds. The parties insured were the owners of those loans, originally being Lehman and SASCO, and ultimately being the Trust. These mortgage loans, with a total value of at least \$1.8 billion, allegedly suffered devastating losses as part of the home mortgage crisis.

In the Sales Agreements by which GreenPoint sold the mortgage loans to GMAC, GreenPoint allegedly made numerous representations and warranties con-

/ continued page 8

U.S. Bank v. GreenPoint

continued from page 7

cerning the viability of the loans. Other representations and warranties were contained in the prospectus and Prospectus Supplement (“ProSupp”), sponsored by Lehman Brothers Holdings and used to sell interests in the loans to investors.

The Allegations

The Trust and the Insurers brought suit in New York state court. The complaint alleged that GreenPoint misrepresented, among other things, the earnings potential of the borrowers on the loans, and that it “pervasively fail[ed] to follow its own underwriting guidelines” in evaluating the loans, rendering them unstable and valueless from the time of their origination. As a result of alleged breaches of the representations

ment” at the time the Sales Agreements were executed, and that the seller, GreenPoint, thus intended that the Insurers would directly benefit from the representations and warranties contained therein.

The Decision

Justice Fried granted GreenPoint’s motion to dismiss the complaint as to the Insurers, holding that there was no evidence that GreenPoint and GMAC intended to confer a benefit on the Insurers at the time those two parties entered into the initial Sales Agreements. The court explained that to establish standing as a third-party beneficiary, it must be clear that a valid and binding contract between two parties was intended to confer a specific and immediate, rather than merely an incidental, benefit on the third party. Here, the “Insurers have

Given the recent rise in litigation involving mortgage-backed securities and the increasing use of such litigation by loan insurers to recoup their massive losses, this decision may have significant impact.

and warranties in the Sales Agreements and other documents, the plaintiffs demanded that GreenPoint repurchase all of the over 30,000 loans in the Trust. GreenPoint denied any breach and argued that, even if there were a breach, the remedy would be limited to its refunding the original value of any individual loan as to which warranties were breached; it would have no duty to reimburse plaintiffs for the cost of the entire pool of loans.

In addition, GreenPoint argued that, because the Insurers were not parties to the Sales Agreement, they lacked standing to bring claims for breach thereof. The Insurers asserted that their standing arose from their status as intended third-party beneficiaries of the Sale Agreements, the ProSupp Agreement and the Indemnification Agreements. They argued that the Sales Agreements “expressly fore[saw] the type of securitization transaction that led to the Insurers’ involve-

not pointed to anything in the mass of documents, including, especially, the Sales Agreements, which would make them direct beneficiaries to these representations and warranties contained in these agreements.” Further, basic rules of contract interpretation prohibit reading ambiguity into a contract such as the Sales Agreement that is complete and clear on its face. The court emphasized that “an intent to apply the warranties and representations contained in the Sales Agreements to the Insurers . . . is patently not in the documents.” Thus, no such intent could be inferred or read into the agreement. Moreover, the court held, parol evidence contained in other agreements could not be used to modify or amend the plain terms of the Sales Agreements.

The court also rejected the Insurers’ claim that later transaction documents, such as the ProSupp and Indemnification Agreements, made them beneficiaries of the warranties in

the agreed sales aspect. Specifically, the Insurers pointed to a provision in the Indemnification Agreements stating that “[a]ll material provided in writing to the [Insurers] for inclusion in the Offering Documents . . . shall be true and correct in all material respects.” The court held that this did not demonstrate the necessary intent on GreenPoint’s part to confer a specific benefit on the Insurers. Justice Fried explained that notwithstanding the Insurers’ “conclusory allegations,” they “fail to show that they were ever intended beneficiaries to any warranties or representations made by GreenPoint in the original Sales Agreements between GreenPoint and GMAC, or any of the later assignees.” The court concluded that the Insurers could not show that they had a right to rely on GreenPoint’s warranties at any point in the series of transactions.

While the claims of the Trustee survived, GreenPoint challenged the remedy sought by the Trustee in the complaint. The Trustee argued that the alleged breaches of representations and warranties required GreenPoint to repurchase the entirety of the 30,000 loans represented in the Sales Agreements; however, GreenPoint contended that it was merely required to repurchase those individual loans as to which a warranty was breached. Analyzing the language in the Sales Agreements, the court concluded that discovery was required to determine whether breaches in individual loans rose to such a level that they implicated the drastic contractual remedy of having the seller repurchase all of the original loans. Thus, the issue could not be disposed of on a motion to dismiss.

Conclusion

Given the recent rise in litigation involving mortgage-backed securities and the increasing use of such litigation by loan insurers to recoup their massive losses, this decision may have significant impact. Absent a direct agreement with the loan originators containing warranties and specifying remedies in the event of a breach, *U.S. Bank v. GreenPoint* suggests that bond insurers may not have standing to sue loan originators for alleged breaches of representations and warranties unless the agreements containing them clearly reflect an intent to benefit the insurers. ☺

Court Imposes Punitive Damages on Lender for Failing to Negotiate Loan Modification in Good Faith

By Thomas J. McCormack and Paige M. Willan

The Supreme Court of the State of New York recently entered judgment in a mortgage foreclosure action imposing punitive damages of \$100,000 on a lender, barring that lender from collecting accrued interest on a loan, barring the lender from recovering its expenses incurred, and limiting the lender’s potential recovery to the outstanding principal balance on the loan. *Emigrant Mortgage Co. v. Corcione*, Index No. 289170/09 (Suffolk Co. Apr. 16, 2010). In imposing these sanctions, the court rebuked the lender for its “shockingly inequitable, bad faith conduct,” and warned that its decision was “an appropriate deterrent to any future outrageous, improper and wrongful activities.”

The Mortgage and Foreclosure

In July 2007, Emigrant Mortgage Company (“Emigrant”) issued an adjustable rate loan secured by a first lien mortgage on the borrowers’ primary residence in Suffolk County, in a principal amount of \$302,500. The initial interest rate was 11.625 percent, but the loan agreement provided that, starting in 2012, the rate could be adjusted yearly based on the average weekly yield of U.S. Treasuries plus 6.375 percent.

In May 2008, allegedly due to a lost job, the borrowers defaulted on the monthly payments, and Emigrant commenced a mortgage foreclosure action. In that action, the borrowers averred that they “assiduously attempted to arrive at an amicable resolution” with Emigrant from the time of their default, but that Emigrant did not respond to their entreaties. The parties participated in a number of court settlement conferences, including one held on March 16, 2010.

New York Law

In 2008, the New York legislature enacted a law setting forth certain procedures that must be followed in a foreclosure action on a subprime, high-cost or non-traditional home loan, including a requirement that lenders negotiate in good faith with a borrower over a possible resolution. / continued page 10

Emigrant

continued from page 9

N.Y. C.P.L.R. § 3408(a) & (f); N.Y. Real Prop. Acts. § 1304; N.Y. Banking § 6(l). To facilitate this mandatory negotiation, the court in such a foreclosure action must hold a conference within sixty days of the filing of proof of service with the county clerk, which both lender and borrower must attend. The lender's representative who participates in this conference must be empowered to "dispose of the case." At the conference, and throughout the action, the new law requires that "[b]oth the plaintiff and defendant [in a covered foreclosure action] shall negotiate in good faith to reach a mutually agreeable resolution, including a loan modification, if possible."

the public records of the taxes levied and paid on the property and, the court found, was "far too round" to be a believable number. Further, the court reasoned that the attorneys' fees of nearly \$8,000 were "both excessive and unreasonable, especially in light of the paucity of services that appear to have been performed." To be recoverable in a mortgage action, attorneys' fees must instead be reasonable and "fairly related" to the amount of work performed by the attorney. As such, the court determined that these fees were inappropriate. As a general matter, the court questioned the recoverability of such fees, costs and accrued interest, given that fourteen months of accruals resulted from the lender's delay in responding to the borrowers' attempts to reach an amicable resolution of their default.

The court determined that an award of \$100,000 in punitive damages to the borrowers was "equitable, necessary and appropriate, both in light of [Emigrant's] shockingly inequitable, bad faith conduct as well as to serve as an appropriate deterrent to any future outrageous, improper, and wrongful activities."

Loan Modification Agreement

At the March 16, 2010 conference, the court examined a proposed loan modification agreement that Emigrant had offered to the borrowers. The court found the terms of this proposal to be — putting it mildly — problematic.

First, the court examined that the amount of accrued interest to be paid thereunder had been computed at sixteen percent. The lender failed to explain why the sixteen percent rate was chosen. Since the borrowers' default in 2008, the accrued interest totaled \$95,154 and was continuing to accrue at a rate of \$132.54 each day.

Second, the court took issue with certain charges to be borne by the borrowers under the proposed modification. Those charges included \$10,000 in "tax and insurance advances," \$7,895 in legal fees, and \$515 in miscellaneous expenses. The court found the tax and insurance figure questionable, because the \$10,000 amount bore no relationship to

Other provisions of the proposed modification were also problematic. For one, the proposal contained a general release by the borrowers to Emigrant which purported to relieve Emigrant from liability for virtually any possible claim that the borrowers might make in the future, including claims under the Truth In Lending Act, for unfair trade practices, consumer fraud and for predatory lending practices. The proposed modification did not contain a similar release from Emigrant to the borrowers. The court observed: "The obvious and facially clear intent of this clause is to circumvent each and every state and federal law in the State of New York intended to regulate the mortgage banking industry."

Another troublesome term was a release by which the borrowers would waive their right to an automatic stay, should they file for bankruptcy. The court noted that, while such a waiver would not be enforceable under applicable law, by including it Emigrant was attempting to do away with "the

most important tool for the protection of the debtor, the creditors and preservation of the estate” in a bankruptcy proceeding and was also attempting to “pre-empt the federal insolvency statutes.”

Indeed, after its review of the proposed modification, the court offered this pointed criticism, particularly about the purported waiver of the bankruptcy stay:

This Court has never been presented with such a waiver, especially when accompanied by absurd representations (drafted by the lender) that amount to what could best be described as an express warranty that Defendants presently are and will forever be insolvent. It is axiomatic that a pre-bankruptcy waiver of such a valuable statutory right, even if freely bargained for (and in this Court’s opinion, this is certainly not the case), should not, under any circumstances, be enforced against consumer debtors such as Defendants. In the view of this Court, such a highly questionable waiver as this one is unconscionable, unreasonable, overreaching and is absolutely void as against public policy. This is even more glaringly true when the Agreement is reviewed in toto and not piece by piece. This Court is constrained to determine that the waiver, the release and indeed the Agreement as a whole is unacceptable for all purposes.

Emigrant’s Failure to Negotiate in Good Faith

The court reviewed New York’s recently enacted law in CPLR § 3408 imposing duties on a lender in certain foreclosure actions to negotiate in good faith. The court concluded that “it is patently clear to this Court that [Emigrant] has failed to act in good faith in this matter.” The court went on to describe, in the harshest of terms, its view of Emigrant’s conduct:

Upon reviewing the totality of the circumstances herein, this Court is driven to the inescapable conclusion that Plaintiff has, by way of calculation and pre-meditation (as evidenced by the terms of its carefully crafted Agreement), created a scenario whereby it is a virtual certainty that Defendants will ultimately be irreparably damaged and further, by way of the [Modification] Agreement, has gone to extraordinary lengths in an attempt to insulate itself from liability while at the same time ensuring that it will not

sustain any pecuniary loss and that all cost will be borne by Defendants. In short, the conduct of Plaintiff in this matter has been over-reaching, shocking, willful and unconscionable, is wholly devoid of even so much as a scintilla of good faith and cannot be countenanced by this Court.

Imposition of Punitive Damages

The court then turned to the consequences of this failure to comply with the good faith negotiation requirement. After noting that a foreclosure action arises in equity, the court reviewed its powers to award punitive damages. According to the court, the rules of equity make exemplary damages available where “the conduct of a party is unconscionable, shocking, or egregious.” Indeed, the New York Court of Appeals has held that the purpose of such damages is to dissuade certain types of behavior for the good of the public at large. *Home Ins. Co. v. Am. Home Prods. Corp.*, 75 N.Y.2d 196, 203-04 (1990); *I.H.P. Corp. v. 210 Cent. Park S. Corp.*, 12 N.Y.2d 329, 333-34 (1963).

Based on the circumstances here, the court determined that an award of \$100,000 in punitive damages to the borrowers was “equitable, necessary and appropriate, both in light of [Emigrant’s] shockingly inequitable, bad faith conduct as well as to serve as an appropriate deterrent to any future outrageous, improper, and wrongful activities.” As a further deterrent to Emigrant’s bad faith conduct, the court ordered that Emigrant was precluded from collecting the interest that had accrued from the date of default in 2008 until March 1, 2010, and was prohibited from collecting its legal fees and other expenses.

Lenders Must Comply with New Foreclosure Rules

The *Emigrant* case illustrates the importance of compliance with New York’s new law applicable to foreclosure actions involving high cost, subprime or non-traditional home loans. The case counsels that any loan modification proposed in furtherance of those rules should not be punitive to the borrower, that interest and fees should be reasonable, and that interest arising from delay on the part of the lender should not be included. Most importantly, the *Emigrant* case serves as a warning about the consequences of a lender’s failure to act in good faith, which here included punitive damages and the loss of the right to collect on interest, fees and costs. ☉

Lender Has No Duty to Act in Good Faith Under Demand Note

By Scott S. Balber and J. Carson Pulley

The United States Court of Appeals for the Seventh Circuit recently ruled that, under Illinois law, when a promissory note provides a lender with the right to demand payment at will, the lender has no obligation to act in good faith in exercising that right to demand payment from the borrower. *Reger Development, LLC v. National City Bank*, No. 09-2821 (7th Cir. 2010). In a unanimous decision, the Seventh Circuit upheld the district court's dismissal of the claims of plaintiff Reger Development, LLC ("Reger") for breach of contract and fraud, despite the fact that defendant National City Bank ("National") had allegedly used its right to demand repayment to attempt to pressure Reger to modify the terms of the loan.

The Note and Dispute

Reger is an Illinois-based real estate development company which, in 2007, approached National for a loan. National advised Reger that its standard loan documents, in the form of a promissory note (the "Note"), were nonnegotiable. Reger accepted the terms of the Note, and National extended a \$750,000 revolving loan to Reger. Significantly, the Note included several provisions which provided that "[Reger] will pay this loan in full immediately upon [National's] demand."

For nearly a year, Reger made timely interest payments on the loan. Nevertheless, in August 2008 National allegedly asked Reger to pay down \$125,000 of principal. Reger complied with National's request the following day. The next month, National asked Reger to "term out" \$300,000 of the Note, replacing it with a three-year loan secured by a mortgage on some of Reger's real estate, and also advised Reger that it would reduce Reger's credit line under the Note by \$250,000 to \$300,000. Reger allegedly asked National whether, if Reger refused to agree to these changes, National intended to demand immediate repayment of the outstanding principal of the existing loan. In response, National allegedly acknowledged that it might demand payment on the line of credit if Reger did not agree. Reger then filed suit for breach of the Note and for fraud on the ground that National had failed to disclose that it could call for the loan to be

repaid on demand. The United States District Court for the Northern District of Illinois dismissed both causes of action, and the appeal to the Seventh Circuit followed.

The Seventh Circuit's Decision

In upholding dismissal of the breach of contract claim, the Seventh Circuit relied upon Illinois law holding that, while generally a covenant of good faith and fair dealing is implied into every contract absent express disavowal, where a loan instrument grants the lender the right to demand repayment at will, a lender has no obligation to accelerate payment only when it has a good faith belief that the prospect of performance by the borrower is impaired. In other words, the right to demand repayment at will imposes no good faith obligation on the lender.

The primary question for the Seventh Circuit was whether the Note provided National with the ability to demand repayment at will. Reger argued that several provisions of the Note were inconsistent with it being a true demand instrument, including a prepayment clause entitling the borrower to prepay all or a portion of the loan "earlier than it is due." Reger also cited to the provision that gave National City the right to access the borrower's financial information, suggesting that this implied repayment could be demanded only in the event of financing insecurity. The Court found these arguments unpersuasive. Relying on the plain language of the Note, the Seventh Circuit found:

We are not persuaded by the suggestion that . . . references to due dates and default somehow overpower the repeated, explicit contract language setting forth the lender's right to demand payment at any time.

The Court also rejected Reger's argument that the bank's use of its right to demand repayment as part of its negotiations over modifications to the loan terms breached the provision of the Note that modifications thereof required the consent of both the lender and the borrower. The Court noted that the bank had presented Reger with two options, live by the terms of the Note and face a possible call on the loan, or agree to restructure the loan terms. Any restructuring, the Court noted, would have required the borrower's consent in accordance with the contractual language. As such, National was free to demand repayment at any time and could use that right to pressure Reger to renegotiate the terms of the loan.

In addition, the Seventh Circuit affirmed dismissal of Reger's fraud claim on the ground that the contract in ques-

tion was not ambiguous and could not have been designed to mislead Reger with respect to National's ability to demand repayment at will. The Court found that a "party cannot close his eyes to the contents of a document and then claim that the other party committed fraud merely because it followed the contract."

Implications for Borrowers

Any borrower who borrows funds under a demand instrument does not enjoy the security of a specific loan term. Moreover, as Reger Development found out, any comfort that a borrower in this situation has that the lender will demand repayment only in the event of financial insecurity may be ill-placed. ☹

Wachovia Agrees to Record Penalties for Lack of Effective Anti-Money Laundering Compliance Programs

By Thomas E. Butler and Christopher Cusmano

Wachovia Bank, N.A. ("Wachovia") recently agreed to pay record penalties of \$160 million as part of a deferred prosecution agreement with the United States Attorney's Office for the Southern District of Florida, arising from its alleged failure to maintain an appropriate anti-money laundering ("AML") compliance program. The agreement was struck in the aftermath of an investigation by federal prosecutors and the Department of Treasury's Financial Crimes Enforcement Network ("FinCEN") into certain transactions involving Mexican currency exchange houses. Authorities found that Wachovia had "willfully failed" to fulfill its anti-money laundering obligations under federal law, and charged the bank with criminal violations of the Bank Secrecy Act. Wachovia accepted responsibility and, under the agreement, forfeited \$110 million, which represented the proceeds of illegal narcotics sales that were laundered through the bank, and also agreed to pay \$50 million in fines.

The Bank Secrecy Act

The Bank Secrecy Act and its implementing regulations obligate domestic banks, insured banks and other financial institutions to establish and maintain certain programs designed to detect and report suspicious activity that might be indicative of money laundering, terrorist financing and other financial crimes. This obligation includes a risk-based AML compliance program, which at a minimum must: (i) provide internal policies and controls designed to guard against money laundering; (ii) designate compliance officials in the bank to coordinate and monitor the program; (iii) offer ongoing employee training programs; and (iv) use independent compliance testing conducted by either bank personnel or an outside party.

In addition, banks that manage correspondent accounts in the United States for non-U.S. persons are under an enhanced obligation to establish due diligence policies to assess the money laundering risk in these types of accounts. The policies must enable the bank to detect suspicious activity based on a variety of factors, including: (i) the nature of the foreign financial institution's business and the market it serves; (ii) the purpose and anticipated activity of the account; (iii) the nature and duration of the bank's relationship with the account holder; (iv) the supervisory regime of the jurisdiction issuing the license for the account holder; and (v) other information reasonably available about the account holder's money laundering record. When these due diligence efforts do detect suspicious activity, banks must file a timely Suspicious Activity Report with FinCEN for transactions that involved or aggregated at least \$5,000.

The Investigation

In 2005, federal authorities began to investigate wire transfers between currency exchange houses in Mexico (commonly known as "casas de cambio," or CDCs) and Wachovia's offices in Miami. CDCs have long been the target of suspicion for money laundering as drug trafficking organizations have increasingly relied on CDCs to place illegal narcotics proceeds into the U.S. financial system. Through a CDC, such organizations can exchange currency and quickly transfer funds between Mexico and the United States.

After the federal government began to investigate Mexican CDCs, many large banks terminated their relationships with CDCs. Wachovia, however, not only remained in this business, but actually expanded the volume of transactions conducted with CDCs. Wachovia offered three pri- / continued page 14

Wachovia

continued from page 13

many services to CDCs which, the government contends, were utilized by the CDCs and their customers to launder illegal narcotics proceeds. First, Wachovia allowed CDCs to conduct wire transfers between Mexico and the bank's business unit in Miami, giving the CDCs direct access to the U.S. financial system. Second, the bank offered a "bulk cash" service, under which CDCs would physically transfer U.S. dollars to Wachovia for deposit. Finally, CDCs would accept deposit items drawn on other U.S. banks, such as personal and traveler's checks, and combine them into a "pouch," which would be delivered physically or electronically to Wachovia for deposit. The federal authorities contended that drug trafficking organizations used these services to transfer large amounts of money between Mexico and the United States to further their criminal enterprises.

AML compliance program, suspicious activity was never discovered or reported. As a result, authorities found Wachovia had "willfully failed" to fulfill its obligations under the Bank Secrecy Act. Some of the most notable violations alleged by the government included:

- ⦿ The failure to ensure sufficient information on foreign correspondent account customers was gathered and reviewed to assess adequately the risk of money laundering;
- ⦿ The lack of critical analysis that compared actual account activity against expected activity;
- ⦿ The existence of specific "gaps and inaccuracies" in the bank's documentation of customer information, such as verification of the account's owner or the nature of the customer's business;
- ⦿ The lack of a quality control system to ensure that information collected was accurate, and that customer information was periodically updated to reflect changes;

The record settlement here demonstrates the government's willingness to pursue alleged lapses in AML compliance with tremendous vigor, and thus the critical importance of maintaining an AML compliance program that satisfies the statutory requirements.

Wachovia's Violations

The investigation of Wachovia's AML compliance program revealed what the government concluded were serious and systemic violations of the Bank Secrecy Act, which in turn enabled individuals to launder at least \$110 million through the bank without detection. In light of the known risk posed by CDC transactions, federal authorities noted many signs that should have alerted Wachovia to investigate these transactions and report suspicious activity, such as the increase in structured wire transactions from Mexican CDCs, the use of sequentially numbered traveler's checks containing unusual markings and identifications, and significant bulk cash transfers in amounts sometimes 50% higher than the account holder's self-identified expectations.

Due to what the government believed was an insufficient

- ⦿ The failure to file timely Suspicious Activity Reports because of budgetary and staffing concerns (some transactions were reviewed three to six months later, meaning any information reported related to dated transactions);
- ⦿ The use of a wire transfer monitoring system that was not commensurate with the high risk posed by CDCs (authorities noted that the system was severely constrained by budgetary and staffing concerns; for example, investigations by bank compliance officials had to be completed in the same month in which they were initiated, and the number of investigations was capped each month based on the number of available investigators, regardless of the amount of traffic);
- ⦿ The failure to establish policies to monitor "bulk cash" transactions, which meant that many transactions were

never examined and information such as the denominations and regional source of the bulk cash was never reviewed; and

- The failure to execute a company policy to review “pouch deposits” over specified amounts, which meant many deposits were never monitored.

Criminal Charges and Settlement

At the conclusion of the investigation, the United States Attorney’s Office for the Southern District of Florida filed a criminal information against Wachovia alleging failure to maintain an AML program in violation of the Bank Secrecy Act. Federal prosecutors and the bank negotiated a deferred prosecution agreement, under which Wachovia agreed to forfeit \$110 million identified by authorities as illegal narcotics proceeds laundered through the bank. In addition, Wachovia was fined \$50 million for these violations and its failure to maintain a sufficient AML compliance program. The bank also consented to a \$110 million civil money penalty assessed directly by FinCEN, which was deemed satisfied by the forfeiture. In total, the penalties were the largest ever paid by a financial institution for violations of the Bank Secrecy Act.

Going Forward

The record settlement here demonstrates the government’s willingness to pursue alleged lapses in AML compliance with tremendous vigor, and thus the critical importance of maintaining an AML compliance program that satisfies the statutory requirements.

Federal banking regulators have emphasized that an effective AML program must be risk-based. To assure the adequacy of a compliance program, banks should incorporate the following “Know Your Customer” principles into their practices:

- Determine the true identity of all customers requesting services;
- Determine the particular customer’s source(s) of funds for transactions;
- Determine the particular customer’s normal and expected transactions;
- Monitor customer transactions to determine if they are consistent with the normal and expected transactions for that customer or for similar categories or classes of customers;
- Identify customer transactions that do not appear to be consistent with normal and expected transactions for that

particular customer or for customers in similar categories or classes; and

- Determine if transactions are unusual or suspicious and, if so, report those transactions. ●

E-mail Confirmations of Credit Card Transactions Not Covered by Fair and Accurate Credit Transaction Act

By Emily Abrahams

You may have noticed over the past several years that your credit card statements and receipts no longer contain your full credit card number. This is because in 2003 Congress enacted the Fair and Accurate Credit Transactions Act (“FACTA”), which amended the Fair Credit Reporting Act. *See* 15 U.S.C. § 1681c. The purpose of FACTA was, among others, to protect consumers from identity theft by prohibiting merchants from disclosing certain credit and debit card information on printed receipts. Violations of FACTA can result in the imposition of statutory damages.

A recent federal district court decision, however, suggests FACTA may not apply as broadly as some consumers may have hoped. In *Shlahtichman v. 1-800 Contacts, Inc.*, 2009 WL 4506535 (N.D. Ill. Dec. 2, 2009), the United States District Court for the Northern District of Illinois dismissed an action brought by a consumer who complained he had received a confirmation of an internet credit card transaction via e-mail and that the e-mail contained the expiration date of his credit card. The court held that because the e-mail confirmation was not an electronically printed receipt covered by the statute, FACTA did not apply.

The Facts

In June 2009, plaintiff Eduard Shlahtichman purchased contact lenses over the internet from defendant 1-800 Contacts, Inc. using his credit card. Following the internet sales transaction, Shlahtichman allegedly received an e-mail confirmation of his purchase, which displayed the expiration date of his credit card.

The relevant FACTA provision, entitled / *continued page 16*

FACTA

continued from page 15

“Truncation of credit card and debit card numbers,” provides that “no person that accepts credit cards or debit cards for the transaction of business shall print more than the last 5 digits of the card number or *the expiration date* upon any receipt provided to the card holder at the point of the sale or transaction.” See 15 U.S.C. § 1681c(g) (emphasis added). That provision provides, however, that it applies only to receipts that are electronically printed. As such, *Shlahtichman* sued 1-800 Contacts seeking statutory damages for improperly displaying the expiration date on the e-mail confirmation he received.

The Court’s Ruling

The court dismissed the lawsuit in its entirety holding that, under FACTA, e-mail confirmations are neither electronically printed receipts, nor are they provided at the point of the sale or transaction. The court’s holding that e-mail confirmations are not printed receipts was based on (1) the plain meaning of those words in FACTA, (2) Congress’s intent to use FACTA to prevent “low tech” means of identify theft such as “dumpster diving” for paper receipts, (3) the reference in the statute to “any cash register or other machine or device that prints receipts for credit card or debit card transactions,” which would be used for printing paper receipts, and (4) the decisions of more than a half dozen cases from other district courts, which determined that e-mail confirmations are not “electronically printed” receipts under FACTA.

The court gave no credence to the small minority of cases holding otherwise, including one from the same district. In determining that an e-mail confirmation is not provided “at the point of sale or transaction,” the court rejected plaintiff’s argument that “the transaction occurs wherever consumers make an on-line purchase” reasoning that “the fact that a consumer can view an e-mail on his home computer [when he can access his e-mail account anywhere in the world] does not mean that the e-mail was directed to that computer at that location.”

Appeal of the District Court’s Decision

On February 1, 2010, plaintiff *Shlahtichman* filed an appeal in the Court of Appeals for the Seventh Circuit seeking reversal of the District Court’s decision on grounds that (1) the words “print” and “point” have multiple established meanings beyond those enunciated by the District Court and, as such,

the applicable FACTA provision is ambiguous, and (2) if Congress intended that provision to create a uniform standard for truncating receipts, it should also apply to internet sales.

In opposition to those arguments, 1-800 Contacts pointed to several statutes distinguishing printed documents from electronic documents, as well as a point of sale from the internet. Those statutes — consistent with the District Court’s decision to abide by the plain meaning of the statute — strongly suggest that by not including a specific reference to e-mail or the internet in 15 U.S.C. § 1681c(g), Congress intended that statute to apply only to printed paper receipts received at the physical point of sale. 1-800 Contacts further cited to congressional debates about FACTA in which U.S. Senators specifically referred to FACTA’s role in preventing identify theft by reducing the amount of information printed on paper receipts. The appellate court heard oral argument on April 15, 2010, but the appeal has not yet been decided. ☺

Court Dismisses Claim That Lender Improperly Disbursed Construction Loan Proceeds

By Francesca J. Perkins

In *Kroeger v. AEC Enterprises Construction, Inc.*, 2009 WL 4981180 (Mich. App. Dec. 22, 2009), the Michigan Court of Appeals affirmed a lower court’s decision summarily dismissing claims that Republic Bank breached a construction loan agreement by disbursing loan proceeds to plaintiffs’ contractor when the contractor’s sworn statements of work completed were allegedly contradicted by the bank inspector’s own progress reports. Relying on the terms of the construction loan agreement, the court concluded that the bank was obligated to advance the construction proceeds or risk liability exposure for its failure to do so.

The Facts

Plaintiffs entered into a construction loan agreement in connection with the construction of their home. Under that agreement, the lender Republic Bank was obligated to release

funds for construction costs upon the submission of a disbursement authorization signed by the borrowers. As a condition to funding, the loan agreement further required the lender's receipt of "a satisfactory report from the Lender's inspector that all completed work and improvements to the Home have been properly constructed . . ."

In March and April of 2006, the borrowers submitted requests that Republic Bank disburse funds. Included with those submissions from the borrowers were sworn statements by their contractor certifying a certain amount of work completed. Those certifications allegedly were inconsistent with a progress report that the bank's inspector provided to the bank showing less work completed than the contractor claimed. While one of the plaintiff-borrowers had signed the disbursement authorizations, the borrowers later concluded that the contractor had failed to perform the work claimed. They sued the contractor and also named the bank as a defendant, asserting that the bank had wrongfully released funds to the contractor. Plaintiffs asserted claims against the bank for breach of contract, breach of fiduciary duty and negligence. The trial court summarily dismissed the borrowers' claims against the bank, and awarded sanctions. The borrowers appealed.

The Court's Ruling

The Court of Appeals first found that the trial court correctly dismissed the breach of contract claim. The court focused on the provision in the loan agreement that obligated the bank to disburse funds on the condition that "the Lender shall have received Borrower's disbursement authorization form signed by anyone of the Borrower(s)," concluding this condition was indisputably satisfied.

The focus then turned to the funding condition that the lender receive a report from its inspector "that all completed work and improvements to the Home have been properly constructed." Significantly, the court observed that this condition was followed by the following sentence: "Each inspection is solely for the benefit of the Lender." The court thus found this condition was for the sole benefit of the lender and, as such, could be waived by the lender.

The court further observed that the loan agreement contained no provision stating that the bank would not disburse funds for work not completed. The court rejected the plaintiffs' assertion that the inspection report funding condition imposed some binding obligation on the bank. Rather, the plain and unambiguous language of the loan agreement

made it clear that this was a condition to funding, waivable by the bank, and thus created no affirmative duty on the bank.

The court also rejected plaintiffs' claim that Republic Bank was subject to an implied covenant of good faith and fair dealing under the loan agreement. The court noted that "Michigan does not recognize a cause of action for breach of the implied covenant of good faith and fair dealing." *Kroeger*, 2009 WL 4981180, at *3 (Mich. App. Dec. 22, 2009), citing *Fodale v. Waste Mgt. of Michigan, Inc.*, 271 Mich. App. 11, 35, 718 N.W.2d 827 (2006).

The plaintiffs' next argument, that the trial court erred in dismissing their breach of fiduciary duty claim because Republic Bank's written and oral assurances created a relationship by which they placed their trust and confidence in the bank, also failed. The court held that, ordinarily, a fiduciary relationship does not arise in the lender-borrower context. Notwithstanding this general rule, the court went on to observe that there was no indication plaintiffs were unable to inspect the progress of the construction themselves and oversee the project on a daily basis. In addition, the plaintiffs' claims that they were "not familiar with the construction loan process or educated regarding banking or contractual terms," lacked merit. The court held that plaintiffs' allegation of inexperience with regard to the process was insufficient to maintain a claim of a fiduciary relationship.

Finally, the court took up the issue of sanctions. Plaintiffs argued that the trial court clearly erred in awarding Republic Bank sanctions for having to defend against frivolous claims. The court held that "the trial court's imposition of sanctions was not in clear error because "there existed no factual or legal support for plaintiffs' claims." *Kroeger*, 2009 WL 4981180, at *5 (Mich. App. Dec. 22, 2009)

Conclusion

The ruling in *Kroeger v. AEC Enterprises Construction, Inc.* suggests that owners should remain actively involved in the disbursement of construction loan proceeds to confirm that funds are not being advanced prematurely. Borrowers would be prudent in not relying on lenders to look after the borrowers' interests, especially where the lenders have no contractual obligation to do so. ☺

National Bank Act Preempts State Law on Customer Fees

By Thomas J. McCormack and Robert Grossman

On December 14, 2009, the United States Court of Appeals for the Sixth Circuit dismissed a claim under Ohio's garnishment law that limits the rights of national banks to impose service fees on customer accounts. *Monroe Retail, Inc., et al. v. RBS Citizens, N.A., f/k/a Charter One Bank, N.A., et al.*, 589 F.3d 274 (2009). The court held that where state law affected the manner in which national banks levied fees and managed their accounts, the provisions of the National Bank Act ("NBA") dealing with the collection of such fees preempted any such state law that was inconsistent with the NBA. This decision could have significant implications for national banks defending their imposition of fees on their customers.

Background

The class action plaintiffs here were garnishor-creditors that had obtained judgments against debtors who maintained bank accounts at national banks. The plaintiffs allegedly had served garnishment orders on the defendant national banks. While the banks complied with the garnishment orders and turned over the account balances to the garnishors, before doing so the defendant banks allegedly deducted service fees of \$25-\$80 from each of the accounts as a processing fee.

The plaintiffs asserted that the national banks were not entitled to levy these service fees under Ohio garnishment law, which provides that (1) service of a garnishment order immediately freezes the funds in the subject account until such funds are paid to the judgment creditor, and (2) banks are limited to a \$1 fee for executing garnishment orders.

The national banks moved to dismiss the action and for judgment on the pleadings on the grounds that, *inter alia*, the NBA authorized the fees at issue and the NBA preempted Ohio law that limited such fees. The district court granted the national banks' motions, and the plaintiffs appealed to the Sixth Circuit.

The Preemption Doctrine

The preemption doctrine is derived from the Supremacy Clause of the Constitution, which provides that the

"Constitution and the laws of the United States . . . shall be the supreme law of the land . . . anything in the constitutions or laws of any State to the contrary notwithstanding." Pursuant to this doctrine, any federal law, including the regulation of a federal agency, prevails over any inconsistent state law.

The national banks were created by the NBA, and the regulations defining a national bank's incidental powers are promulgated by the Officer of the Comptroller of the Currency ("OCC"), the federal agency charged with regulating and supervising national banks. In *Monroe Retail*, the Sixth Circuit Court of Appeals observed that while ordinarily "a presumption against preemption applies," the Supreme Court has held that this presumption is inapplicable in the context of national banking. See *Watters v. Wachovia Bank, N.A.*, 550 U.S. 1, 12 (2007).

Application of the Preemption Doctrine

The OCC's regulations characterize the imposition of fees on customers as an "incidental power" of a national bank. See 12 C.F.R. § 7.4002(a). While the parties agreed that this regulation empowered national banks to impose fees, the central question in *Monroe Retail* concerned whether under these facts this regulation preempted Ohio law.

The plaintiffs maintained that the preemption doctrine was inapplicable because another OCC regulation, 12 C.F.R. § 7.4007(c), exempted from the preemption doctrine state laws governing "rights to collect debts." The national banks countered that this regulation exempted only state laws governing the right of the national banks (and not the right of plaintiffs) to collect debts. The Sixth Circuit rejected the national banks' position as inconsistent with the text of the regulation and unsupported by case law. The court also observed that the national banks' interpretation of 12 C.F.R. § 7.4007(c) was highly illogical because it suggests that the NBA would preempt state law only with respect to debt collection issues that *do not* relate to national banks.

Although the Sixth Circuit held that the NBA did not preempt general state debt collection laws, it went on to consider whether the plaintiffs' specific claim under Ohio's garnishment statute was preempted. The national banks had solicited OCC's view on this question and, in response, OCC issued an opinion letter stating that (1) its regulations authorized the banks to impose and collect fees at their discretion, and (2) preventing the banks from imposing a garnishment processing fee in excess of \$1 would "significantly interfere"

with this authority. The OCC also advised that its regulations empower national banks to determine the order in which fees are posted to an account such that a bank may levy its service fee prior to freezing that account pursuant to a garnishment order.

The Sixth Circuit recognized that OCC's interpretation of the NBA is entitled to substantial deference and ultimately accepted OCC's view that its regulations authorized national banks to impose fees and determine the order in which those fees are collected. The Court further acknowledged that the "requirement that banks freeze accounts immediately upon receipt of a garnishment order is unduly burdensome on national banks because it mandates the order in which those banks carry out their daily account-balancing and account management functions." Accordingly, the Court held that "any interpretation of the Ohio garnishment statute that would allow the [plaintiffs'] claim to proceed is preempted by the NBA's grant of authority to the [b]anks to collect fees without interference."

Implications for National Banks

Although *Monroe Retail* addressed only the propriety of garnishment processing service fees, the court's holding may have broader implications for national banks because it arguably sets a broad rule for the preemption of state laws that impact a bank's ability to impose fees on customers. Indeed, in light of the finding that the Ohio garnishment statute "significantly interfered" with such bank authority, one could argue that other state laws impacting bank fees — such as state laws concerning overdraft fees — are similarly improper. *But see In re: Checking Account Overdraft Litigation*, 09-MD-02036 (S.D. Fl. March 11, 2010) (holding that while 12 C.F.R. § 7.4002(a) authorizes national banks to charge overdraft fees, it does not preempt state law contract and tort claims). ☺

Court Dismisses Securities Fraud Claims Against Canadian Imperial Bank of Commerce

By Alan I. Raylesberg and Caroline Pignatelli

The United States District Court for the Southern District of New York has granted the motion of Canadian Imperial Bank of Commerce ("CIBC") to dismiss the complaint in a securities fraud action where plaintiff alleged that defendants misled investors about CIBC's exposure to fixed-income securities backed by subprime residential mortgages. In *Plumbers & Steamfitters Local 773 Pension Fund v. Canadian Imperial Bank of Commerce*, No. 08 Civ. 8143, 2010 WL 961596 (S.D.N.Y. Mar. 17, 2010), the court determined that the complaint failed to allege facts sufficient to give rise to an inference of scienter.

The Claims

Lead plaintiff Plumbers & Steamfitters Local 773 Pension Fund brought a putative class action against CIBC and four of its officers alleging that the defendants misled investors about CIBC's exposure to fixed-income securities backed by subprime residential mortgages in violation of Section 10(b), 15 U.S.C. §§ 78j(b) and 20(a), and 15 U.S.C. § 78t(a) of the Securities Exchange Act of 1934. The defendants moved to dismiss the Consolidated Class Action Complaint pursuant to Fed. R. Civ. Proc. 12(b)(6).

Plaintiff sought to represent a class of: (i) all purchasers of CIBC securities on the New York Stock Exchange and (ii) all U.S. persons who otherwise acquired CIBC securities during the period of May 31, 2007 to May 29, 2008 (the "Class Period"). At the beginning of the Class Period, CIBC allegedly owned \$11.5 billion worth of assets collateralized by subprime mortgage loans. Of that \$11.5 billion, \$9.8 billion was hedged, meaning that CIBC purchased insurance through a counterparty to assume the risk of default. ACA Financial Guaranty Corporation ("ACA") hedged \$3.5 billion thereof.

The complaint alleged that defendants "immersed" CIBC in the mortgage-backed securities market and then misled investors about the bank's exposure as the value of those assets deteriorated. Specifically, plaintiff's primary allegations were: (i) defendants made misrepresenta-

CIBC

continued from page 19

tions in at least fourteen public statements or press releases issued during the Class Period; (ii) defendants failed to take timely write-downs relating to the subprime mortgage market; and (iii) defendants failed to identify that ACA, which was experiencing extreme financial difficulty, hedged a significant portion of CIBC's mortgage-backed securities. In summary, "[t]he gravamen of this litigation is that CIBC, as owner of these securities in the midst of a U.S. mortgage crisis, misled investors about the firm's mortgage-backed holdings and its relationship with ACA Financial."

facts or had access to information suggesting that their public statements were not accurate; or (4) failed to check information they had a duty to monitor."

Public Statements

With respect to the alleged misrepresentations contained in fourteen statements or press releases, the court determined that there is no allegation that any defendant benefitted in "a concrete and personal" way from the alleged fraud. To the contrary, the complaint demonstrated that CIBC purchased approximately \$300 million of its own stock during the Class Period and that three of the four individual defendants also purchased additional stock. Further, the defendants did not

This case demonstrates that the courts are not receptive to generalized hindsight based allegations to support a claim for fraud. Instead, to sustain a claim for securities fraud, plaintiffs generally must point to specific facts that give rise to an inference of scienter.

Legal Standard

The court explained that "[t]o state a claim for misrepresentation under Section 10(b) and Rule 10b-5, a plaintiff must allege that each defendant '(1) made misstatements or omissions of material fact, (2) with scienter, (3) in connection with the purchase or sale of securities, (4) upon which the plaintiff relied, and (5) that the plaintiff's reliance was the proximate cause of its injury.'" Further, pursuant to Fed. R. Civ. P. 9(b) there is a heightened pleading standard for securities fraud which requires that, "the circumstances constituting fraud . . . shall be stated with particularity" (citing *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000)).

With respect to scienter, the court explained, relying on the Second Circuit decision of *Novak v. Kasaks*, that there are four kinds of deceitful behavior that if well-pled give rise to a "strong inference" of scienter: "where the defendants: (1) benefited in a concrete and personal way from the purported fraud; (2) engaged in deliberately illegal behavior; (3) knew

sell their stock immediately prior to a price drop, "suggesting the absence of any nefarious motives." With respect to the second "strong inference" of the scienter, there were no allegations in the complaint that the defendants deliberately engaged in illegal behavior.

The court then examined the third and fourth *Novak* categories of inferences of scienter, that the defendants "knew facts or had access to information suggesting that their public statements were not accurate . . . or . . . failed to check information they had a duty to monitor." To satisfy these categories, the complaint, "*must specifically identify* the reports or statements' that are contradictory to the statements made." The court determined that the plaintiff did not provide specific contradictory information such as internal CIBC documents or confidential sources discrediting defendants' claims that they were "adapting to a 'rapidly changing economic landscape' during a 'once-in-a-century credit tsunami.'"

The court rejected plaintiff's argument that the defendants received information contradicting their statements because they held managerial roles at CIBC and monitored CIBC financial reports because "broad reference to raw data" is insufficient to plead scienter. With respect to the public statements that plaintiff identified in support of its contentions, the court further discussed that the complaint failed to identify any obligation that requires the defendants to disclose CIBC's mortgage-backed holdings and "Defendants were not obligated to respond to every potentially disparaging news story or to rebut the musings of the financial press."

Finally, the court relied on the Supreme Court case of *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 323-324 (2007), for the proposition that the inference of scienter is not to be considered by the court in a vacuum. Instead, the statements must be considered against alternative explanations. Following that direction, the court explained how the complaint describes an "unprecedented paralysis of the credit market and a global recession" and that "major financial institutions . . . imploded as a consequence of the financial dislocation." Although the court acknowledged that, "a full turn of the wheel would have been appropriate . . . [CIBC's] incremental measured response, while erroneous in hindsight, is as plausible an explanation for the losses as an inference of fraud." The court commented that CIBC "could not have been expected to anticipate the crisis with the accuracy Plaintiff enjoys in hindsight."

Write-Downs

Plaintiff also alleged that the defendants failed to take timely write-downs on mortgage-backed securities. However, "[b]ecause the securities laws do not allow fraud by hindsight claims, after-the-fact 'allegations that statements in one report should have been made in earlier reports do not make out a claim of securities fraud.'" Instead, the appropriate standard is "whether the failure to take a write-down amounted to 'highly unreasonable [conduct] which represents an extreme departure from the standards of ordinary care.'" The court held that, similar to the "Defendant's alleged misstatements, the Complaint is bereft of factual allegations from which a reader could infer Defendants intentionally or recklessly failed to take write-downs on U.S. mortgage-backed securities." To the contrary CIBC "adopted an incremental strategy" and took six write-downs during the Class Period.

ACA Disclosures

Finally, with respect to plaintiffs' allegations regarding defendant's failure to disclose that the failing ACA hedged a significant portion of the hedged securities, the court commented that the allegations against ACA were "particularly tenuous because they rest on the notion that Defendants failed to disclose internal financial information of a company *other than CIBC*." The court articulated that the plaintiffs failed to allege that defendants had knowledge of, access to, or could collect information that ACA was in danger of, bankruptcy and "[e]ven an egregious failure to gather information will not establish 10b-5 liability so long as the defendants did not deliberately shut their eyes to the facts."

Conclusion

The court granted defendant's motion to dismiss in its entirety holding that "Plaintiffs have failed to plead scienter and Defendants' motion to dismiss the § 10(b) and Rule 10b-5 claims is granted." As liability under Section 20(a) requires a primary violation by a control person (which the court determined there was no primary violation of Section 10(b) and Rule 10b-5), the court also granted the motion to dismiss this claim. This case demonstrates that the courts are not receptive to generalized hindsight-based allegations to support a claim for fraud. Instead, to sustain a claim for securities fraud, plaintiffs generally must point to specific facts that give rise to an inference of scienter. ☺

Identities of Banks Borrowing at Discount Window Not Exempt from FOIA Requests

By Alan I. Raylesberg and Benjamin D. Bleiberg

In two related opinions decided the same day, the Second Circuit Court of Appeals held that the Freedom of Information Act ("FOIA") requires the Board of Governors of the Federal Reserve System to disclose the identities of the private banks that had received loans from the Federal Reserve Banks at the Discount Window or under other emergency lending programs in the wake of the recent economic / *continued page 22*

Federal FOIA Disclosures

continued from page 21

crisis. *Bloomberg, L.P. v. Board of Governors of the Federal Reserve System*, No. 09-4083, 2010 U.S. App. LEXIS 5694 (2d Cir. Mar. 19, 2010); *Fox News Network, LLC v. Board of Governors of the Federal Reserve System*, No. 09-3795, 2010 U.S. App. LEXIS 5695 (2d Cir. Mar. 19, 2010). The Court found that FOIA's Exemption 4, which exempts certain confidential financial information from disclosure, did not apply to the requested loan information. The Court further required the Board to search the Federal Reserve Banks' records for loan information responsive to FOIA requests.

The FOIA Requests

In response to a weakening national economy and looming financial crisis, the Board of Governors of the Federal Reserve System (the "Board") took several unprecedented steps to provide liquidity to banks in need of funds. In late 2007, the Board authorized the Federal Reserve Banks ("FRBs") to establish the Term Auction Facility ("TAF"), a new Discount Window-style lending facility for depository institutions. When the Board found that liquidity still did not sufficiently improve by March 2008, it further authorized the Federal Reserve Bank of New York to create additional emergency lending programs to provide greater access to liquidity: the Primary Dealer Credit Facility and the Term Securities Lending Facility.

Seeking information about the loans the FRBs made at the Discount Window and under these new emergency loan programs, Bloomberg, LLP ("Bloomberg") submitted two FOIA requests to the Board. In part, Bloomberg requested the names of the private banks that received loans from the FRBs, the amounts they borrowed, the origination and maturity dates of the loans, and the collateral for loans made from April 4, 2008 to May 20, 2008. Similarly, Fox News Network, LLC ("Fox") submitted two FOIA requests seeking the names of private banks that received loans from the FRBs under any of the lending programs, the amounts they borrowed, and the collateral for loans made from August 2007 to November 2008 and from September 2008 to October 2008. Fox sought the information on the grounds that tax funds were dispersed to particularly troubled institutions in economically perilous times via untested and unprecedented methods, and the public deserved transparency regarding these funds.

The Board admitted that it possessed responsive information regarding the banks' identities, loan amounts and loan dates in the Board's "Remaining Term Reports," but denied

both news organizations' requests on the grounds that FOIA Exemptions 4 and 5 exempted the requested information from disclosure. Exemption 4 exempts commercial, financial, or trade secret information that is "obtained from a person" and is privileged or confidential. 5 U.S.C. § 552(b)(4). Exemption 5 protects "inter-agency or intra-agency memorandums or letters which would not be available by law to a party other than an agency in litigation with the agency." 5 U.S.C. § 552(b)(5). The Board did not search the FRBs' lending records for information regarding the pledged collateral on the grounds that the FOIA requests to the Board did not require it to search them.

Suit is Filed

Bloomberg and Fox subsequently brought separate suits in the United States District Court for the Southern District of New York to compel disclosure of the responsive loan information and to compel the Board to conduct a search of the FRBs. Ruling on cross motions for summary judgment in the *Bloomberg* case, Chief Judge Loretta Preska held that the Board's Remaining Term Reports were not exempt from FOIA disclosure under Exemptions 4 and 5, and required the Board to search certain FRB records for responsive information. Ruling on cross motions for summary judgment in the *Fox* case, Judge Alvin Hellerstein came to the opposite conclusion, holding that the information was exempt under Exemption 4, and that the Board was not required to search the records maintained by the FRBs. Because the information was exempt under Exemption 4, the opinion did not address the applicability of Exemption 5.

The Board appealed the holding in the *Bloomberg* case, arguing that Exemption 4 properly applies to the requested materials. The Board, however, did not challenge the lower court's ruling regarding the limited scope of Exemption 5, or its obligation to conduct a search of the FRBs' records. Fox also appealed the adverse holding against it in the *Fox* case. Deciding both appeals the same day, the Second Circuit Court of Appeals held that the Exemption 4 did not apply to the news organizations' FOIA requests and that the Board must search the FRBs' records — affirming the lower court's holding in *Bloomberg* and reversing and remanding the lower court's holding in *Fox*. The Court did not address the applicability of Exemption 5, finding that the Board had waived the issue.

The Bloomberg Decision

In holding that the Board was required to disclose the names

of the private banks that received loans, the amounts they borrowed, and the dates of the loans, the Second Circuit applied a three-part test to determine whether FOIA Exemption 4 applied. Under the test, the Board could withhold the requested loan information only if the information (1) is financial information, (2) was “obtained from a person,” and (3) was “privileged or confidential.” Bloomberg conceded that the loan information was financial information, the very reason it made the FOIA requests, and, accordingly, the Court only addressed the second two factors.

The Court first held that the borrowing banks’ loan information, located in the Board-generated Remaining Term Reports, was not “obtained from a person.” Bloomberg argued that its FOIA requests to the Board did not seek any loan applications obtained from the borrowing banks. Instead, the requests sought only documents that reflected Board-

eral for a loan application, the loans “did not come into existence until the Federal Reserve Bank took executive action by granting the loan.” The information Bloomberg requested was generated within the FRBs after their decision to grant a loan. In reaching this conclusion, the Court took a narrow view of Exemption 4’s “obtained from” language, reasoning that information about a borrowing bank that can be inferred from information generated within the FRBs does not mean that the information was “obtained from” the borrowing bank within the meaning of FOIA.

The Court also held that the loan information transferred from the FRBs to the Board was not “privileged or confidential.” Information is confidential for the purposes of Exemption 4 when its disclosure would cause substantial harm to the competitive position of the person from whom the information was obtained. Although the Board argued

The Second Circuit’s reading of FOIA in its two pro-disclosure decisions may have far-reaching implications that may mitigate the intended purpose of the Fed’s emergency lending programs of injecting much-needed liquidity and instilling confidence in the country’s financial institutions during a period of economic uncertainty.

generated information which detailed the loans the FRBs actually made to the borrowing banks. In response, the Board argued that the sought-after loan information located in the Board’s Remaining Term Reports was generated solely by the borrowers themselves, not the FRBs, and therefore should be considered information “obtained from” the borrowing banks. The Board explained that the loans were automatically granted based on the borrower-generated data, and that the FRBs would simply “review the request, verify collateral and, if approved, enter the loan in the Reserve Bank’s loan and accounting system.”

The Court disagreed with the Board’s argument that the FRBs had no discretion whether to grant the loans. Because they were required to formally approve any acceptable collat-

that the FRBs were persons from whom it obtained the responsive information, it did not attempt to establish that disclosure of the requested information would cause competitive injury to the FRBs.

Finally, the Court further declined to adopt the First and District of Columbia Circuits’ “program effectiveness test,” which would have provided the Board with tremendous discretion to withhold the loan information as confidential. Under the program effectiveness test, agencies are permitted to withhold information as confidential under Exemption 4 if they believe that withholding it “serves a valuable purpose and is useful for the effective execution of its statutory responsibilities.” The Board argued that information regarding the Discount Window and other / *continued page 24*

Federal FOIA Disclosures

continued from page 23

emergency loan programs should be exempt because its disclosure would impair its mission “to furnish critical infusion to distressed banks on a confidential basis — and thereby prevent loss of confidence, bank runs, fluctuation of bank stock and rippling harm to the banking system.”

Despite stating that the Board’s argument — “that disclosure would harm the banks that borrowed (by disclosing their prior distress) and the banking system as a whole (because banks under stress may hesitate to seek relief or rescue)” — “are plausible, and forcefully made,” the Court found that the program effectiveness test would grant the Board “impermissible deference.” The Court analogized the program effectiveness test to FOIA’s Exemption 5 “public interest” standard rejected by the Supreme Court in *Fed. Open Market Comm. v. Fed. Reserve Sys. v. Merrill*, 443 U.S. 340 (1979). The Supreme Court held that the test “would leave little, if anything to FOIA’s requirement of prompt disclosure, and would run counter to Congress’s repeated rejection of any interpretation of FOIA that allows an agency to withhold information on the basis of some vague ‘public interest’ standard.”

The Court concluded that the scope of disclosures under FOIA is a matter of congressional policy, and stated that if the Board believed an exception to FOIA that contemplates the identities of borrowers at the Discount Window and other emergency loan program should exist, it should petition Congress to amend the statute.

The Fox Decision

Applying the reasoning in its ruling in *Bloomberg* to Fox’s appeal, the Second Circuit held that the Board must disclose the identities of the borrowing banks and other loan information sought by Fox. The Court then examined the single issue of whether the Board was required to search the records of each of the twelve FRBs. Materials are considered “agency records,” and searchable pursuant to FOIA, if (1) the agency created or obtained the relevant records, and (2) the agency was in control of the documents at the time of the FOIA request. The Board’s regulations define the Board as the official custodian of all “Board records” in the FRBs’ possession, and define “Board records” as records that “are maintained for administrative reasons in the regular course of business in official files in any division or office of the Board or any Federal Reserve Bank in connection with the transaction of any official business.”

The Court concluded that the context and phrasing of the regulations required the Board to search the FRBs’ records to determine which records held by the FRBs were Board Records under the definition of the regulation. The Court remanded to the district court to address the appropriate scope of the search, as well as to revisit other FOIA-related issues not decided during the initial proceedings.

Conclusion

The Second Circuit’s reading of FOIA in its two pro-disclosure decisions may have far-reaching implications that may mitigate the intended purpose of the Fed’s emergency lending programs of injecting much-needed liquidity and instilling confidence in the country’s financial institutions during a period of economic uncertainty. While fears of potential runs on borrowing institutions whose identities could now be disclosed may be overstated, the Court’s rulings have forced cash-strapped financial institutions to make the difficult choice between publishing their liquidity deficiencies to obtain emergency funding and foregoing the loans and risking financial collapse. ☺

Wells Fargo Sanctioned for Failing to Mediate in Good Faith

By Thomas J. Hall and Andrea Voelker

In a decision that may influence how parties and their counsel respond to court-ordered mediation, the Bankruptcy Court for the Southern District of New York ruled that Wells Fargo Bank (“Wells Fargo”) failed to participate in good faith in a court-ordered mediation, even though a bank representative and counsel attended the mediation session and in fact made a settlement offer at the mediation. *In re A.T. Reynolds & Sons, Inc.*, 424 B.R. 76 (Bankr. S.D.N.Y. 2010). In imposing civil sanctions and penalties, the court relied on its Mediation Order, General Orders M-211 and M-390 of the Southern District of New York Bankruptcy Court, which govern the court’s mediation program, and other statutory and case law authority. The court ruled that mere attendance at a court-ordered mediation is not enough to satisfy the good faith obligation where, the court found, the party demonstrated an unwillingness to participate actively in the mediation process.

Background

Following the Chapter 11 bankruptcy filing of debtor A.T. Reynolds & Sons, Inc., the debtor was sold at auction to Boreal Water Collection (“Boreal”). Thereafter, Boreal filed a motion seeking reimbursement for its payment of wage claims that were filed by the debtor’s employees for the week prior to Boreal’s acquisition of the debtor. The court granted the motion, but did not specify who was to pay Boreal. The debtor then filed a motion for reconsideration asserting that Wells Fargo, a secured lender, controlled the disbursement of the debtor’s cash collateral pursuant to a cash collateral order. The debtor further asserted that this payment issue was effectively a dispute between Boreal and Wells Fargo. Although Wells Fargo was not named as a party to the motion practice over this payment issue, it was served with both the original

support thereof, the mediator asserted that the Wells Fargo representative attending the mediation was a “junior” relationship manager, and its counsel too was “junior,” that they did not possess full settlement authority, that they maintained a “no-pay” position throughout the mediation, and that they were not open to discussing the merits of the case. The report further asserted that the Wells Fargo representatives insisted on limiting the issues to be discussed at the mediation and, in fact, after the mediator told them that he intended to report their bad faith to the court, Wells Fargo allegedly threatened the mediator that he would never again be chosen as a mediator in any matter involving Wells Fargo.

Wells Fargo responded that its representatives at the mediation were “senior,” its counsel having ten years of experience, that they had full settlement authority, that Second Circuit

Parties that do not participate in good faith in mediation are subject to a variety of sanctions and other penalties. 28 U.S.C. § 1927 allows courts to order attorneys to pay their adversaries the costs of unreasonably duplicative proceedings.

motion and the motion for reconsideration and its involvement in this dispute was highlighted in both sets of papers. In response, the court ordered all parties — the debtor, CCV Restructuring, Boreal, Wells Fargo, and the Committee of Unsecured Creditors — to participate in settlement mediation.

After the mediation, the mediator notified the court that he would be issuing a report asserting that Wells Fargo failed to participate in the mediation in good faith. In response, the court issued an order to show cause, requiring Wells Fargo and its counsel to show cause as to why they should not be sanctioned for contempt of the Mediation Order and General Order M-390.

The Mediation

The mediator filed his report with the court in which he contended that Wells Fargo failed to participate in good faith. In

law provides that a court cannot force parties to settle, and that Boreal failed to send a principal to the mediation. Wells Fargo further argued that, because it was not a named party to the motion giving rise to the mediation, it was unaware of the full content of the dispute to be mediated and, accordingly, was unable to prepare for it properly.

Following these various submissions, the court held a hearing at which the parties offered testimony and other evidence.

The Legal Structure

Under 28 U.S.C. § 473(a)(6), district courts have the authority to order mediation. The mediation program for the Bankruptcy Court in the Southern District of New York was adopted in 1993, and was governed by General Order M-211 in 2009, the year the mediation here took place, and is currently governed by General Order M-390. The / continued page 26

A.T. Reynolds & Sons

continued from page 25

mediation program requires parties to participate in good faith, allows for sanctions to be imposed upon offending parties, and places the mediator in control of the mediation, relieving him or her from confidentiality rules to report delinquent parties.

Parties that do not participate in good faith in mediation are subject to a variety of sanctions and other penalties. 28 U.S.C. § 1927 allows courts to order attorneys to pay their adversaries the costs of unreasonably duplicative proceedings. Federal Rules of Civil Procedure Rule 16 also allows a court to order parties to attend pre-trial conferences and to give out sanctions where a party fails to participate in good faith.

Relevant precedent includes *Negron v. Woodhull Hosp.*, No.

The Court's Analysis

Citing various sources on dispute resolution and mediation, the court emphasized the purpose of mediation and the critical components required to make it effective. The court specifically noted that the purpose of mediation is not about winning or losing the case, but rather identifying the potential risk exposure. Citing the mediator's report, the court stressed the importance of representatives attending the mediation having the authority to change their positions and that the decision-makers participate in person and not by telephone. The court also stressed the importance of listening, working with the mediator and the other parties to develop solutions, and engaging in a substantive discussion of risk analysis.

The court addressed the cases cited by Wells Fargo in its

As this case demonstrates, district courts and bankruptcy court judges have statutory teeth to compel parties to participate in mediation in good faith, including by imposing sanctions and civil penalties.

05-4147-CV, 2006 WL 759806 (2d Cir. Mar. 23, 2006), in which the Second Circuit ruled that, where a party does not participate in good faith in a court-ordered mediation, the traditional remedy is for the culpable party to pay the costs incurred by the other parties in attending the mediation. Additionally, in *In re Chief Executive Officers Clubs, Inc.*, 359 B.R. 527 (Bankr. S.D.N.Y. 2007), the Bankruptcy Court for the Southern District of New York found that Bankruptcy Courts have inherent authority to issue sanctions and hold a party in civil contempt in order to enforce their orders, where "(1) the order the party allegedly failed to comply with is clear and unambiguous, (2) the proof of noncompliance is clear and convincing, and (3) the party has not diligently attempted in a reasonable manner to comply."

defense, including *Negron*, which stated *in dicta* that assuming a "no-pay" position in a mediation does not necessarily constitute bad faith, and that "a party is not required to change its settlement parameters by reason of a court order to attend a settlement conference." The court responded that, to read *Negron* as allowing a party prior to the mediation to limit itself to a sole settlement option, would be to render the mediation process meaningless. Rather, the court read *Negron* as precluding courts from forcing settlements on parties after the mediation has concluded. The court similarly rejected Wells Fargo's other legal authorities, finding that they also did not excuse Wells Fargo's conduct in the mediation.

The court found guidance in the case *Fisher v. SmithKline Beecham Corp.*, No. 07-CV-0347A(F), 2008 Dist. LEXIS 76207 (W.D.N.Y. Sept. 29, 2008), in which the court imposed sanctions on a party and required it to pay the costs of the media-

tion where the party failed to participate in mediation in good faith. In that case, the offending party filed a motion for summary judgment the day before the mediation, and refused to move off of the nominal settlement offer it made unless the other party could successfully argue against a point of law set forth in the summary judgment motion. Finding Wells Fargo's conduct similarly culpable, the court noted that Wells Fargo also went into the mediation with a predetermined settlement amount and a fixed mind-set that it was not liable.

Failure to Participate in Good Faith

The court took particular issue with several actions of the Wells Fargo representatives at the mediation. The court admonished Wells Fargo for trying to "wrest" control of the mediation from the mediator by refusing to discuss issues that were not previously raised by debtor's counsel, resisting providing a mediation statement, constantly interrupting the mediation and by insisting prior to the mediation on knowing the identities of the representatives of other parties who would be attending the mediation, in violation of General Order M-211. The court also criticized Wells Fargo's pre-mediation determination of no liability and its "no-pay" stance that prevented it from even considering settlement. The court further noted that the sole settlement proposal made by Wells Fargo at the mediation came only after the mediator advised he would report Wells Fargo's bad faith conduct to the court, and even then the offer came following a private phone conversation with an unknown party who was not in attendance, suggesting that the Wells Fargo representatives in attendance lacked authority.

As a result of these findings, the court sanctioned Wells Fargo under Rule 16(f) of the Federal Rules of Civil Procedure for failing to participate in good faith, and sanctioned its counsel pursuant to 28 U.S.C. § 1927 for "vexatiously causing a fruitless mediation session and subsequent hearing on the mediator's report of failure to participate in the mediation in good faith." The court held both Wells Fargo and its counsel in contempt of the Mediation Order, which incorporates both General Orders, and required that Wells Fargo and its counsel reimburse the other parties for the cost of mediation.

Conclusion

Not surprisingly, courts expect parties attending mediations to approach mediation with respect for the process and with a flexible mind-set open to settlement. While neither a court nor

a mediator can compel a party to settle, they can require parties to engage in a meaningful dialogue about the case, including risk assessments of potential liability. As this case demonstrates, district courts and bankruptcy court judges have statutory teeth to compel parties to participate in mediation in good faith, including by imposing sanctions and civil penalties. ☺

FINRA and NASD Entitled to Absolute Immunity

By Scott S. Balber and Kimberly Zafran

The United States District Court of the Southern District of New York recently dismissed two consolidated putative class actions against the National Association of Securities Dealers, Inc. ("NASD") and the Federal Industry Regulatory Authority ("FINRA") arising from the 2007 merger of NASD and the regulatory arm of the New York Stock Exchange ("NYSE") that created FINRA. Plaintiffs, who were NASD members at the time of the consolidation, asserted that defendants made misrepresentations in the proxy statement used to solicit NASD shareholder votes. The court held that the defendants had absolute immunity as self-regulatory organizations ("SROs") performing regulatory functions.

The Decision

The two related cases were consolidated in *Standard Investment Chartered, Inc. v. Nat'l Assoc. of Securities Dealers, Inc.*, Nos. 07 Civ. 2014 (JSR), 08 Civ. 11193 (JSR), 2010 WL 749844 (S.D.N.Y. Mar. 1, 2010). Plaintiffs, who were NASD members, alleged that the proxy statement that solicited the NASD votes in favor of the merger falsely asserted that \$35,000 was the maximum amount that NASD, a non-profit entity, was authorized by the IRS to pay members in connection with the merger. Defendants moved to dismiss on many grounds, the most important of which was their claim that they were entitled to absolute immunity. The court decided the case solely on this ground.

The court noted that the Securities Exchange Act of 1934 authorized the Securities Exchange Commission ("SEC") to delegate its regulatory functions to SROs, which are then considered "quasi-governmental bodies." As a result, the SROs enjoy the same immunity from private damage suits challenging official conduct performed within / continued page 28

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Standard Investment Chartered

continued from page 28

the scope of their regulatory functions as the SEC.

When analyzing a claim against an SRO that enjoys immunity, the first step in the immunity analysis is a determination of whether the acts or omissions that give rise to the claims are deemed regulatory as the existence of immunity protection turns on “whether specific acts and forbearances were incident to the exercise of regulatory power, and not on the propriety of those actions or inactions.” *Id.* at *1, citing *In re NYSE Specialists S.E.C. Litig.*, 503 F.3d 89, 98 (2d Cir. 2007). The plaintiffs argued that the specific act challenged of making a misstatement in a proxy statement pertained to the proprietary functions of SROs, to which absolute immunity does not apply. They argued that this misstatement related to defendants’ finances, not regulatory powers.

The court found that the plaintiffs’ attempt to distinguish the proxy at issue here was “artificial and unconvincing.” Judge Rakoff found that the approval of FINRA’s by-laws, which was a part of the proxy, was clearly a regulatory issue. Furthermore, amending by-laws is a clear regulatory function granted to NASD under its statutory rule-making authority. The court believed that focusing on the financial component of the proxy would be to miss the greater purpose at issue, which was the reorganization of these entities, which was clearly regulatory in nature. Based on this reasoning, the court granted defendants’ motion to dismiss with prejudice, ruling that the transfer of NASD’s and NYSE’s regulatory powers to the resulting FINRA was patently an exercise of a regulatory function which is entitled to absolute immunity.

Conclusion

As explained above, Judge Rakoff’s decision, though brief and dismissive, reads considerable breadth into the scope of an SRO’s regulatory function entitled to immunity. This decision could prove quite burdensome for future plaintiffs against SROs as the SRO defendants will likely take advantage of this broad reading of what is a regulatory function. ☺

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