Banking Legislation & Policy

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HIGHLIGHTS

Recent Developments

Citigroup Settles Enron Class Action Suit for $2 Billion

On June 10, Citigroup announced that it had agreed to a settlement in the Enron class action suit, *Newby v. Enron Corp*. Under the settlement, which is currently pending in the U.S. District Court for the Southern District of Texas, Citigroup agreed to make a $2 billion pre-tax payment to the class of plaintiffs, which consists of all purchasers of publicly traded equity and debt securities issued by Enron and Enron-related entities between September 9, 1997, and December 2, 2001. The settlement stipulates that Citigroup denies violating any law and is only agreeing to the settlement to avoid the uncertainties, burden, and expense of further litigation.

Citigroup is one of several financial institutions involved in the suit. The plaintiffs allege that the financial institutions violated federal securities laws by creating sham transactions and concealing and mischaracterizing loans, which helped enable Enron to defraud investors of more than $25 billion.

FDIC Issues Cease and Desist Order to Payday Lender

The Federal Deposit Insurance Corporation (FDIC) issued a cease and desist order to County Bank in Rehoboth, Del., which requires the bank to develop more controls over its payday lending partnerships. Within 90 days of the order, the bank is required to have in place information and internal auditing and control systems to monitor and oversee its partnerships with payday lenders and ensure that they operate using safe and sound banking principles. Within 15 days of the order's issuance, the bank must ensure that each of its merchant payday lending partners adheres to its requirements relating to periodic paydowns, cooling off periods, charge-offs, and documentation. The bank is required to appoint a "compliance" committee composed of three people who have never been involved in the bank's day-to-day operations. The committee will monitor the bank's compliance with this order, and its findings will be reported to the FDIC every three months.

SUMMARY OF FEDERAL LEGISLATION

New Legislation

1. Credit Card Minimum Payment Notification Act (S. 1040). Introduced by Sen. Feinstein (D-Calif.) on May 16, 2005.

Status: Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill requires credit card issuers to include in each monthly billing statement a warning about the consequences of making only the minimum payment. Card issuers have one of two options. First, they can provide individualized disclosures explaining how long it will take to pay off the customer's current balance if he or she pays only the minimum payment, and how much this costs in finance charges. In this case, they must also include the toll-free telephone number of the National Foundation for Credit Counseling or another accredited credit counseling agency. (These requirements are similar to those contained in the recently enacted Bankruptcy Abuse Prevention and Consumer Protection Act. For more information, see *Banking Legislation and Policy*, January – March 2005.) There is an exemption from these requirements if the account agreement requires a minimum payment of at least 10 percent of the outstanding balance or if no finance charges are imposed during the billing cycle.

Alternatively, credit card issuers can choose to make more generic disclosures, explaining how long it will take to pay off $1,000, $2,500, and $5,000 balances if the cardholder makes only the minimum monthly payments, the account has a 17 percent annual percentage rate (APR), and the minimum payment is $10 or 2 percent, whichever is greater. The issuer also has to state the total amount the cardholder will pay in finance charges under this scenario.

Monthly statements for retail credit cards, which are issued by retailers like stores or oil companies, are required to have similar disclosures for all cardholders with an account balance of more than $500, but using smaller balance amounts as examples. Retail credit card issuers are required to state how long it will take cardholders to pay off balances of $250, $500, and $750 when making only the minimum payment and assuming that the account carries a 21 percent APR and requires a minimum payment of $10 or 5 percent, whichever is greater.

If a card issuer opts to make generic disclosures, it is required to provide a toll-free telephone number that customers can use to get individualized information about the length of time and the cost of paying off their specific account balances given their APRs and minimum payment requirements.

This bill also requires the Federal Trade Commission to publish a table showing the cost and length of time it takes to pay off different account balances at different APRs and with different required minimum payment amounts.

2. Innocent Check Depositor Protection Act (H.R. 2643). Introduced by Rep. Weiner (D-NY) on May 25, 2005.

Status: Referred to the House Subcommittee on Financial Institutions and Consumer Credit.

This bill prohibits depository institutions from charging a bounced-check fee to the depositor of a check that is not honored due to insufficient funds.

3. Fair Choice and Competition in Real Estate Act of 2005 (H.R. 2660). Introduced by Rep. Oxley (R-Ohio) on May 26, 2006.

Status: Referred to the House Committee on Financial Services.

This bill would amend the Bank Holding Company Act of 1956 to make real estate brokerage and real estate management activities permissible for financial holding companies and the financial subsidiaries of national banks. The bill defines real estate brokerage activities as any of the following: acting as an agent for a buyer, seller, lessor, or lessee; listing or advertising property for sale or rent; providing advice in connection with a real estate sale or rent; bringing together parties interested in the sale or rental of real estate; negotiating a real estate contract; or any other activity that requires a person to be registered or licensed as a real estate agent or broker.

The bill defines a real estate management activity as any of the following: finding a tenant for a real estate property; negotiating real estate leases; maintaining security deposits on rented real estate properties; billing and collecting rental payments; making principal, interest, insurance, tax, or utility payments with respect to real property; or overseeing the inspection, maintenance, and upkeep of real property.

4. Communities First Act (H.R. 2061). Introduced by Rep. Ryun (R-Kan.) on May 3, 2005.

Status: Referred to the House Committees on Financial Services and on Ways and Means.

This is a broad bill intended to exempt small, community-oriented banks from a number of regulations.

Supervision: The bill requires the Board of Governors of the Federal Reserve System (the Board) to publish rules that would permit bank holding companies (BHCs) with consolidated assets of less than $1 billion to file a shorter report of its financial and managerial condition (known as the Small Bank Holding Company Statement on Assessment of Financial and Managerial Factors) as long as the BHC is not engaged in nonbanking activities involving significant leverage and does not have a significant amount of outstanding debt. The Federal Deposit Insurance Corporation (FDIC) is required to adjust this $1 billion threshold each year by the percentage increase in the total amount of assets held by all depository institutions in the previous year. Banks are not permitted to file abbreviated reports for consecutive quarters.

Currently, only BHCs with consolidated assets of less than $150 million are permitted to file the abbreviated version. The rules also increase the allowable debt-to-equity ratio from 1:1 to 3:1 for BHCs to pay dividends and be eligible for expedited processing under Regulation Y, a Board rule that regulates BHCs and changes in bank control.

The bill makes community bank examination schedules more flexible, allowing regulators to determine the frequency with which examinations are conducted instead of requiring annual exams. This applies to all banks with less than $1 billion in total assets, an increase from the current threshold of $250 million.

Community Reinvestment: Institutions with less than $1 billion in total assets are eligible for a less-frequent Community Reinvestment Act examination schedule. The current threshold is $250 million. Banks making fewer than 100 home mortgage loans in any year are exempt from making disclosures required under the Home Mortgage Disclosure Act (HMDA). The bill also permits the Board to modify the definition of any metropolitan statistical area for purposes of the HMDA.

Corporate Governance: Community banks are also not subject to an annual management assessment of internal controls, which is required by the Sarbanes-Oxley Act of 2002, if they had total assets of $1 billion or less at the close of the previous year. Additionally, the bill raises the threshold for an exemption from limitations on extensions of credit to executive officers, directors, and principal shareholders from $1 million to $1 billion in total assets.

Taxes: In general, the bill allows community banks that are C corporations to receive a 20 percent tax credit, not to exceed $250,000. In low-income, renewal, or distressed communities, these banks receive a 50 percent tax credit, not to exceed $500,000. Community banks that are S corporations can reduce their amount of taxable income by 20 percent or $1.25 million, whichever is less. In low-income, renewal, or distressed communities, S corporation community banks can reduce their taxable income by 50 percent or $2.5 million, whichever is less. Community banks, in these scenarios, are considered to be any bank, bank holding company, thrift, or thrift holding company with less than $500 million in gross assets.

Truth in Lending: The bill permits the Board to allow consumers borrowing from insured depository institutions to waive the statutory three-day right of rescission in connection with consumer credit transactions.

Other Provisions: The bill requires federal regulators to conduct several studies. The Board is required to study the reporting procedures required under the HMDA. The FDIC, the Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision are required to review and streamline the procedures for community banks making reports of condition. In each case, the agencies are required to conduct the studies every five years and report their results to Congress.

5. Renewing the Dream Tax Credit Act (H.R. 1549). Introduced by Rep. Reynolds (R-NY) on April 12, 2005.

Status: Referred to the House Committee on Ways and Means.

This bill provides a tax credit to low- or middle-income homeowners who construct or renovate homes in economically depressed areas, including rural areas, Indian tribe reservations, and census tracts with median gross incomes of less than 80 percent of the statewide median gross income. Qualified homeowners are awarded a tax credit spread over five years equal to 50 percent of the residence's current tax basis (excluding land). Qualified homeowners include families earning less than 80 percent of the median gross income (70 percent for families with one or two members). In low-income census tracts, families could earn 100 percent of the median gross income and still be eligible for a tax credit (90 percent for families with one or two members). The credit applies to any of the following types of residences, as long as they serve as the owner's primary residence: single-family homes, condominium units, or stock in a cooperative housing corporation. However, in properties that have more than one housing unit, an owner only receives credit for the portion of the residence in which he or she lives.

6. Appropriations Bill for Fiscal Year 2006 (H.R. 3058). Introduced by Rep. Knollenberg (R-Mich.) on June 24, 2005.

The House of Representatives passed its appropriations bill for the Departments of Transportation, Treasury, and Housing, the Judiciary, the District of Columbia, and other independent agencies for the fiscal year ending September 30, 2006. The bill includes a provision that prohibits credit card companies from increasing the interest rate charged on a person's account solely because of negative information about that individual reported by other institutions to credit reporting agencies. In other words, an institution could increase an interest rate because of negative information obtained from a credit report only if that information pertained to the person's account at that same institution.

Pending Legislation

1. Expanded Access to Financial Services Act of 2005 (H.R. 749). Introduced by Rep. Gerlach (R-Pa.) on February 10, 2005.

Status: Passed the House; Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill permits credit unions to provide services to nonmembers, as long as they are eligible for membership. Under the bill, people who are eligible for credit union membership can buy checks, travelers checks, money orders, and other money transfer instruments (such as electronic fund transfers) from a particular credit union even if they are not official members of that credit union. Credit unions can also charge a fee to cash checks and money orders and receive electronic fund transfers for people who are eligible for membership even if they are not members.

2. Mortgage Servicing Clarification Act (H.R. 1025). Introduced by Rep. Royce (R-Calif.) on March 1, 2005.

Status: Passed the House; Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill would amend the Fair Debt Collection Practices Act to exempt mortgage servicers of federally related mortgage loans from the mandatory debt collection disclosures required by the act if they became responsible for a loan after it was already in default. (A mortgage loan is considered to be federally related if the lender is regulated by a federal agency.) Specifically, the mortgage servicer would be exempt from the requirement that he or she disclose to consumers in initial communications that any information gathered will be used in an attempt to collect debt.

3. Federal Deposit Insurance Reform Act of 2005 (H.R. 1185). Introduced by Rep. Bachus (R-Ala.) on March 9, 2005.

Status: Passed the House; Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill reforms the deposit insurance system. The bill combines the Bank Insurance Fund and the Savings Association Insurance Fund into a new Deposit Insurance Fund (DIF) into which all future assessments would go. The bill also increases from \$100,000 to \$130,000 the amount of deposit insurance coverage per account offered by the Federal Deposit Insurance Corporation, and this amount is adjusted every five years to account for inflation. It also increases insurance coverage for municipal deposits and retirement accounts and establishes a range for calculating payments into the DIF. Currently there is a fixed reserve ratio to calculate deposit insurance payments, but the bill allows the board of directors of the Federal Deposit Insurance Corporation to change the reserve ratio depending on a number of factors, including the DIF's risk of losses and the current economic conditions affecting the insured depository institutions.

This bill is identical to previous years' reform bills. For more information, see *Banking Legislation and Policy*, January-March 2003, for a summary of last session's deposit insurance reform bill.

4. Business Checking Freedom Act of 2005 (H.R. 1224). Introduced by Rep. Kelly (R-NY) on March 10, 2005.

Status: Passed the House; Referred to the Senate Committee on Banking, Housing, and Urban Affairs.

This bill would repeal sections of the Home Owners' Loan Act and the Federal Deposit Insurance Act that prohibit depository institutions from paying interest on business checking accounts. The bill allows businesses to make up to 24 transfers each month from their interest-bearing accounts to their other accounts at the same institution.

Industrial loan companies owned by commercial firms are still prohibited from offering business NOW accounts, but there is an exemption for any industrial loan company that was FDIC-insured or had applied for FDIC insurance before October 1, 2003.

The bill also requires Federal Reserve Banks to pay interest on reserve balances at least once each quarter, in accordance with rules that are to be developed by the Board of Governors of the Federal Reserve System (the Board) after this bill's enactment. The Board is also required to complete a study and report to Congress annually about different bank fees and services relating to checking accounts, negotiable order of withdrawal (NOW) and savings accounts, automated teller machine transactions, and other electronic transactions. The bill also gives the Board greater flexibility in setting the reserve requirements, allowing it to choose a reserve requirement ratio between 0 and 3 percent for banks with deposits of \$25 million or less, and between 0 and 14 percent for banks with deposits of more than \$25 million.

Board of Governors of the Federal Reserve System

Customer Identification Programs (4/28)

The Board of Governors of the Federal Reserve System, the Financial Crimes Enforcement Network, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Department of the Treasury (together, the Agencies) released a list of answers to frequently asked questions regarding customer identification programs required under the USA PATRIOT Act. The guidance stresses that institutions are to develop risk-based procedures for verifying the identity of customers, and any standards recommended in the guidance are to be supplemented by other, individualized risk-based procedures.

The guidance clarifies that foreign subsidiaries of a bank, bank holding companies (BHCs), and BHCs' nonbank subsidiaries are not required to implement customer identification programs, but other bank subsidiaries are required to implement them.

The guidance is intended to be a quick-reference guide for banks, instructing them on how to handle a variety of situations, including what constitutes a "customer" for purposes of identifying his or her identity and how to properly verify the identity of a customer in different situations. It also clarifies what types of bank services qualify as "accounts" for purposes of customer identification programs.

For more information, see www.fincen.gov/faqsfinalciprule.pdf.

Mortgage Loan Accounting and Reporting (5/3)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of Thrift Supervision (together, the Agencies) issued a guidance instructing banks on how to account for commitments to originate and sell mortgage loans. The Agencies issued this guidance because they noticed that some institutions were improperly accounting for such commitments on their balance sheets. For example, some institutions were failing to report these as derivatives on their balance sheets and income statements, which would have required them to report changes in their fair value.

The guidance clarifies that commitments to originate mortgage loans that will be held for resale are derivatives, and the issuer must account for them at fair value on the balance sheet. An example would be an interest rate lock (a promise by a mortgage broker to lend money to a borrower at a guaranteed interest rate) for a loan a bank intends to sell.

Agreements to sell mortgage loans must also be treated as derivatives if they satisfy conditions specified in the Financial Accounting Standards Board's Statement of Financial Accounting Standards, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 133). If these conditions are satisfied, the loans must also be accounted for at fair value on the balance sheet.

The guidance specifies two types of commitments to sell mortgage loans that are considered derivatives: mandatory delivery contracts and best-efforts contracts. A mandatory delivery contract is a loan sales agreement in which an institution commits to deliver a certain number of mortgage loans to an investor at a specified price or by a specified date. If the institution does not fulfill its commitment, it is obligated to pay a fee to the investor to compensate for the shortfall. A best-efforts contract is a loan sales agreement in which an institution commits to deliver an individual mortgage loan of a specified principal amount and quality to an investor if the loan to the underlying borrower closes. A best efforts contract would be considered a derivative if it has all of the following characteristics: 1) it includes an underlying amount, which is the amount an investor will pay to buy the loan; 2) it includes a notional amount, which is the original loan amount; 3) it requires little or no initial net investment; and 4) it permits net settlement.

For more information on this guidance, see www.federalreserve.gov/boarddocs/srletters/2005/SR0510a1.pdf.

Home Equity Lending (5/16)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) issued a guidance describing sound risk management systems for open- and closed-end home equity lines of credit (HELOC). The Agencies focused on risks associated with loans underwritten with: 1) interest-only features; 2) limited or no documentation of the borrower's assets, income, or employment; 3) inadequate validation of collateral values; 4) high loan-to-value and debt-to-income ratios; and 4) a low credit-risk score. To address these concerns, the Agencies require that financial institutions use appropriate credit risk management procedures. These procedures should evaluate both individual borrowers and the institution's overall portfolio of HELOCs.

First, risk management personnel should be involved in the product development process. Also, if the loans are marketed or closed by a third party, the financial institution must have standards to be sure the third party makes quality loans and complies with federal laws and regulations.

Before extending a HELOC, financial institutions should thoroughly evaluate a borrower's ability to pay, taking into consideration his or her income and debt levels, credit score, credit history, and the size of the loan. Particularly for interest-only loans, financial institutions should consider the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

Financial institutions should also establish collateral valuation policies and procedures. The procedures should provide guidelines to help determine which valuation method to use based on the particular transaction. Financial institutions should not furnish appraisers with the valuation calculations, which appraisers might use to automatically appraise for the desired value. When using alternative valuation models, financial institutions should check past valuations periodically to ensure that they produce accurate results.

The Agencies also recommend that financial institutions monitor HELOC accounts to evaluate if borrowers are still able to repay a loan or if they are overextending themselves. To do so, the Agencies suggest periodically rechecking borrowers' credit scores, periodically assessing payment patterns, and monitoring home values by geographic area. Financial institutions should use these or any number of other techniques before extending interest-only periods or approving additional credit. Also, financial institutions should employ these techniques to determine whether to freeze or reduce credit lines.

For more information, see www.federalreserve.gov/boarddocs/press/bcreg/2005/20050516/default.htm.

Truth in Savings (5/24)

The Board of Governors of the Federal Reserve System (the Board) issued a final rule to amend Regulation DD, which implements the Truth in Savings Act, to require depository institutions to provide more information to consumers about overdraft fees. First, if a depository institution promotes some form of overdraft protection in advertisements, the institution is required to disclose in periodic statements the total amount of fees charged for paying the overdrafts and the total amount of fees charged for returning items unpaid. The disclosures must include totals for the month and year-to-date. In addition, at the time a customer opens an account, institutions must disclose the types of transactions that may incur overdraft fees. Institutions are only required to provide a general list (for example: overdrafts created by checks, ATM withdrawals, in-person withdrawals, or other electronic means, as applicable). The final rule also clarifies that depository institutions are prohibited from making misleading advertisements about accounts with overdraft protection. See *Banking Legislation and Policy*, April-June 2004, for a more detailed description of the proposed rule.

This final rule becomes effective July 1, 2006. For more information, see 70 *Federal Register*, pp. 29582-96.

Office of the Comptroller of the Currency

Medical Information Privacy (6/10)

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (together, the Agencies) issued an interim final rule to implement sections of the Fair and Accurate Credit Transactions Act regarding sharing and using a person's medical information. The rule defines medical information as any information provided by a health-care provider or consumer that relates to a person's past, present, or future physical, mental, or behavioral health. This does not include information about a person's gender, age, or demographic information (such as an address). In general, the rule does not permit creditors to request or use a person's medical information to make any determination about his or her eligibility for credit, except in the following circumstances.

Creditors may use the medical information to make a determination about a person's eligibility for credit in the following cases: 1) the information is routinely used in making a determination about credit, such as information about debts, expenses, or benefits; 2) the information is used in a manner consistent with and no less favorable than nonmedical information; and 3) the creditor does not consider the person's mental, physical, or behavioral health in making the determination.

The rule also provides many other specific exceptions to the prohibition. First, medical information can be used to determine whether a medical event triggers a power of attorney to be assigned, eliminating a person's legal capacity to contract. Next, medical information can be used if it is required by local, state, or federal laws. Also, medical information can be used at the consumer's request to determine whether he or she is eligible for special credit programs made available for consumers with certain medical conditions. Furthermore, creditors are not prohibited from using medical information to determine if a person's medical condition triggers other provisions of his or her debt contract, including debt cancellation and suspension agreements, forbearance agreements, credit insurance products, or other types of benefits.

If a creditor receives medical information about a consumer, the creditor is prohibited from disclosing it to any other party, unless it is necessary to facilitate the transaction for which the information was originally obtained. The rule also prohibits creditors from sharing medical information with their affiliates. In addition, creditors may not share with their affiliates any lists that show which consumers bought which medical products or services. The rule makes an exception for the sharing of medical information among affiliates in the insurance and annuities businesses.

Comments on this interim final rule were due July 11, and it becomes effective March 7, 2006. For more information, see 70 *Federal Register*, pp. 33958-96.

Federal Deposit Insurance Corporation

Tuition Savings Programs (6/9)

The Federal Deposit Insurance Corporation (FDIC) issued an interim final rule with a request for comments that would allow tuition savings programs invested in a state-run trust to be insured on a "pass-through" basis. These types of trusts would ordinarily be considered corporations for purposes of deposit insurance, meaning that the aggregate deposits in the trust would only be insured for up to $100,000 instead of $100,000 per participant in the trust. Before this rule, trusts could be established by their owners directly through depository institutions, which would allow an individual trust to be insured for up to $100,000.

However, the Securities and Exchange Commission (SEC) is requiring tuition savings program trusts to register with the SEC unless they are invested in a state public instrumentality, such as a state investment trust or other state entity. For that reason, many trust owners are joining a state investment trust instead of registering with the SEC. However, prior to this interim final rule by the FDIC, the entire state investment trust would have only been eligible for deposit insurance coverage of up to $100,000, regardless of the number of trusts or owners invested in the state program. Now, by granting pass-through coverage to the state investment trusts, they are eligible for up to $100,000 of deposit insurance coverage per account in the trust, as long as each account can be traced back to one or more investors and the trust makes the disclosures required by the FDIC for pass-through coverage.

This interim final rule became effective June 9, and comments on it were due August 8. For more information, see 70 *Federal Register*, pp. 33689-92.

SUMMARY OF JUDICIAL DEVELOPMENTS

FCRA Partially Preempts the California Financial Information Privacy Act

The U.S. Court of Appeals for the Ninth Circuit ruled that the California Financial Information Privacy Act (also know as SB1) is partially preempted by the Fair Credit Reporting Act (FCRA) as it concerns information sharing among affiliates (*American Bankers Association v. Gould*, No. 04-16334). The FCRA regulates the use of consumer reports, which are defined as "any written, oral, or other communication of any information by a consumer reporting agency bearing on a consumers' credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living." The FCRA excludes from this definition information shared between affiliates, but the act also specifically preempts any state laws that seek to regulate information sharing among affiliates. (The FCRA was amended in 2003 by the Fair and Accurate Credit Transactions Act, which imposes additional standards for information sharing among affiliates. For more information about this law, see *Banking Legislation and Policy*, October-December 2003.)

In 2003, California passed SB1, which prohibits financial institutions from sharing consumers' nonpublic personal information with affiliates unless the financial institution notifies the consumer annually in writing that his or her information may be shared and the consumer does not request otherwise. In response, the American Bankers Association brought this suit, arguing that SB1 is preempted by the FCRA.

The U.S. Court of Appeals for the Ninth Circuit ruled that SB1 is only preempted where it seeks to regulate the specific types of information that the FCRA regulates, meaning information about a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living. However, the court ruled, insofar as SB1 pertains to other types of information, it is not preempted by the FCRA. Therefore, the court remanded the case to district court, where it will be determined how much of SB1 concerns these specific types of information and whether the remainder of the law is valid after those provisions are preempted.

Auto Dealer's Failure to Disclose a Rebate Is Not a Violation of the TILA

On May 20, the U.S. Court of Appeals for the Ninth Circuit ruled that an automobile dealer did not violate the Truth in Lending Act (TILA) by failing to disclose a $2,000 rebate that was made available to customers who did not receive a low 0.9 percent annual percentage rate on their auto loans (*Virachack v. University Ford*, No. 03-55852). The plaintiffs, Malinee and Ritnarone Virachack, bought a Ford Explorer from University Ford's Bob Baker Ford business in San Diego, Calif., in November 2001. They paid for the Ford mostly by credit, and Bob Baker Ford extended them an auto loan with a 0.9 percent interest rate. At the same time the Virachacks bought their vehicle, Bob Baker Ford was offering a $2,000 rebate on the same vehicle model and year to customers who did not receive the 0.9 percent financing. This rebate was not included in the Bob Baker Ford's TILA disclosures.

The Virachacks brought suit against University Ford for failing to provide notice of the rebate. They alleged that this failure was a violation of the TILA, and they were not able to make informed use of credit as a result. The district court found in favor of University Ford, and the Virachacks appealed. On appeal, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court's opinion, saying that the TILA does not require University Ford to make such disclosures. The court said that, in this case, the TILA would have been violated had Bob Baker Ford used the rebate as a way of inducing customers to use means other than credit. However, the court found that this was not the case. In fact, as Bob Baker Ford's finance manager attested, the rebate would have been available to any customer using any means of payment, as long as they were not also receiving the low 0.9 percent APR, as Ford Motor Company did not want to give two incentives to the same customer.

Banks Not Required to Warn Other Creditors of Debtors' Insolvency

The U.S. Court of Appeals for the Seventh Circuit ruled that Wachovia Bank (previously First Union) is not liable for failing to warn other creditors that a mutual debtor was high-risk and financially unstable (*B.E.L.T., Inc. v. Wachovia Corporation*, No. 04-1812). CoreStates Bank (whose successor was First Union National Bank, which later merged into Wachovia) granted a credit line to Lacrad International Corporation in 1997 and gave the company's executives credit cards, which they used heavily. By 1999, after Lacrad was in debt to First Union for more than $2 million, First Union froze the credit line but continued to accept payments from Lacrad. Lacrad, in turn, borrowed from other lenders and used the loans to pay down the First Union debt. The other lenders brought suit against First Union to recoup these funds, contending that First Union should have warned them or bank regulators that Lacrad was financially unstable, in which case Lacrad would have collapsed sooner, before borrowing as much from the other lenders.

The U.S. Court of Appeals for the Seventh Circuit found that First Union had no duty to report what it might have suspected about Lacrad's financial condition to other lenders, since Illinois law "does not require business ventures to do good turns for their rivals." In fact, state law advises banks not to tell other private parties about their borrowers' activities. The court ruled that First Union, itself, did not act fraudulently, because fraud requires a representation made with intent to deceive, and First Union did not make any representation to the other lenders. Furthermore, banks are not required to report to their regulators the financial problems of nonbanks. For these reasons, the court dismissed the claims against Wachovia.

No Fiduciary Duty to Report a Borrower's Fraud to Other Lenders

The U.S. Court of Appeals for the Second Circuit ruled that State Street Bank and Trust Company did not have a duty to warn other lenders that its debtor, Sharp International Corp., was financially unstable (*Sharp International Corp. v. State Street Bank and Trust Company*, No. 04-0214-bk). Sharp International Corp. was primarily owned by three brothers, the Spitzes, who, over a period of several years, participated in a fraudulent scheme in which they inflated the company's net sales in order to obtain loans for large sums of money. In turn, the Spitzes stole these funds and other company profits, diverting more than $44 million from Sharp to their other entities in 1998 and 1999 alone.

One of Sharp's lenders, State Street Bank, became suspicious of the company's activities and began to investigate its sales and financial statements. As the bank became increasingly wary, it began to request more documentation from the Spitzes and investigated the company's checks to see if large payments had been made to the Spitzes. At the conclusion of its investigation, State Street quietly arranged for the Spitzes to repay their loans using funds from other lenders. To do so, Sharp sold subordinated notes to raise $25 million ($10 million more than was required to repay the State Street debt). In order to sell the notes, Sharp needed State Street's written consent, which the bank gave.

Sharp and the noteholders brought suit against State Street, arguing that State Street should have blown the whistle on Sharp, which would have prevented the Spitzes from defrauding other lenders and stealing more money from the company. The plaintiffs also argued that by giving Sharp consent to sell the notes, State Street participated in the Spitzes fraudulent scheme, making State Street culpable.

The court explained that in order for State Street to be found guilty of fraud, it would have to have had actual knowledge of the scheme and knowingly induced or participated in it. While it is unclear whether the bank had actual knowledge of the fraud, the court found that there was clearly not sufficient evidence that State Street induced or participated in it, which would have required State Street to have provided "substantial assistance" to the Spitzes. The court found that, at most, the bank took no action to report the Spitzes fraud, and failure to act does not constitute substantial assistance under New York law unless the bank owed a fiduciary duty to the plaintiffs, which it did not. In fact, the court reasoned that State Street owed a fiduciary duty to its own shareholders to protect them and recoup the funds lent to Sharp, rather than helping other lenders, who had the same opportunity to discover the Spitzes' looting and fraud if they had tried. For these reasons, the court affirmed the lower courts' opinions and dismissed the case.

Court Upholds Georgia's Payday Lending Restrictions

The U.S. Court of Appeals for the Eleventh Circuit ruled that Georgia is permitted to enforce its law that bars in-state businesses from partnering with out-of-state banks in order to circumvent Georgia's usury laws that prohibit in-state businesses from making high-cost payday loans (*Bankwest, Inc. v. Baker*, No. 04-12420). Georgia law prohibits its in-state businesses from making loans of $3,000 or less and charging anything greater than an annual percentage rate (APR) of 16 percent interest. Typically, payday loans carry APRs of about 400-500 percent, meaning in-state businesses are effectively prohibited from making payday loans.

To circumvent this prohibition, Georgia payday lenders enter into partnerships with out-of-state banks, which are not governed by the Georgia law and can charge whatever interest rate is permitted by their home state. In these partnerships, the Georgia business will advertise, procure, process, and maintain the payday loans, even though the out-of-state bank will decide whether to approve the loan and provide the loan funds. In return, the payday lender recoups around 80 percent of the loans' proceeds and shares the risk of loss with the out-of-state bank.

Georgia has attempted to prohibit these partnerships by making it illegal for in-state businesses to act as agents for out-of-state banks when the in-state business holds the predominant economic interest in the payday loans. An in-state business is considered to hold the predominant economic interest if it receives more than 50 percent of the revenue from the loan. The Georgia law does not seek to prohibit out-of-state banks from acting on their own to grant payday loans in the state, nor does it prohibit partnerships where the in-state agent receives 50 percent or less of the loan's revenue.

The in-state payday lenders and out-of-state banks brought suit against Georgia, arguing that its payday lending partnership law is preempted by the Federal Deposit Insurance Act, which permits banks to export their home-states' interest rates to other states in which they conduct business. The court found that the Georgia law is not preempted by federal law under any of the three categories of preemption: field, conflict, or express. First, because federal law does not seek to regulate the entire *field* of banking and leaves some authority to states, it is not preempted in this case. Further, there is no *conflict* between the Georgia law and federal law, because it is possible to satisfy both, and the Georgia law does not obstruct the rights created by federal law. The express form of preemption is not applicable here because federal law only regulates the activities of the out-of-state bank in this case, and the Georgia law does not prohibit out-of-state banks, acting on their own, from charging whatever interest rate they choose. Because the Georgia law only restricts out-of-state banks from this one specific partnership in which the in-state business holds the predominant economic interest in the loan, the court upheld the Georgia law and ruled that it is not preempted by federal law.

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