Foreseeing the Impact of

BY GREG TAYLOR

YOU'RE THE NEW COMPLIANCE OFFICER *at a well-run, mid-sized savings institution. It's 9:15 on a Monday morning and you're in a meeting with an outside vendor. You're looking for a way to keep abreast of emerging regulatory and litigation trends that could expose the bank to unnecessary risk. The vendor is pitching a product that sounds almost too good to be true.*

"So you are telling me that you have developed a product that will let me know in advance of any significant legal or regulatory development that could affect the bank?"

The vendor takes a box from her briefcase and places it on your desk. She slowly opens it and lifts out a solid, translucent glass sphere about 10 inches in diameter. Dangling from the bottom of the sphere is a cord with a USB connector on the end. The vendor smiles.

"What is this thing?" you ask.

"It's a crystal ball, updated for the 21st century," she begins. "It has an Internet connection that provides direct access to our staff of consultants via the BankPsychic Network. For a small monthly charge and a $2 per-use access fee, you can just plug it in, and ask it anything."

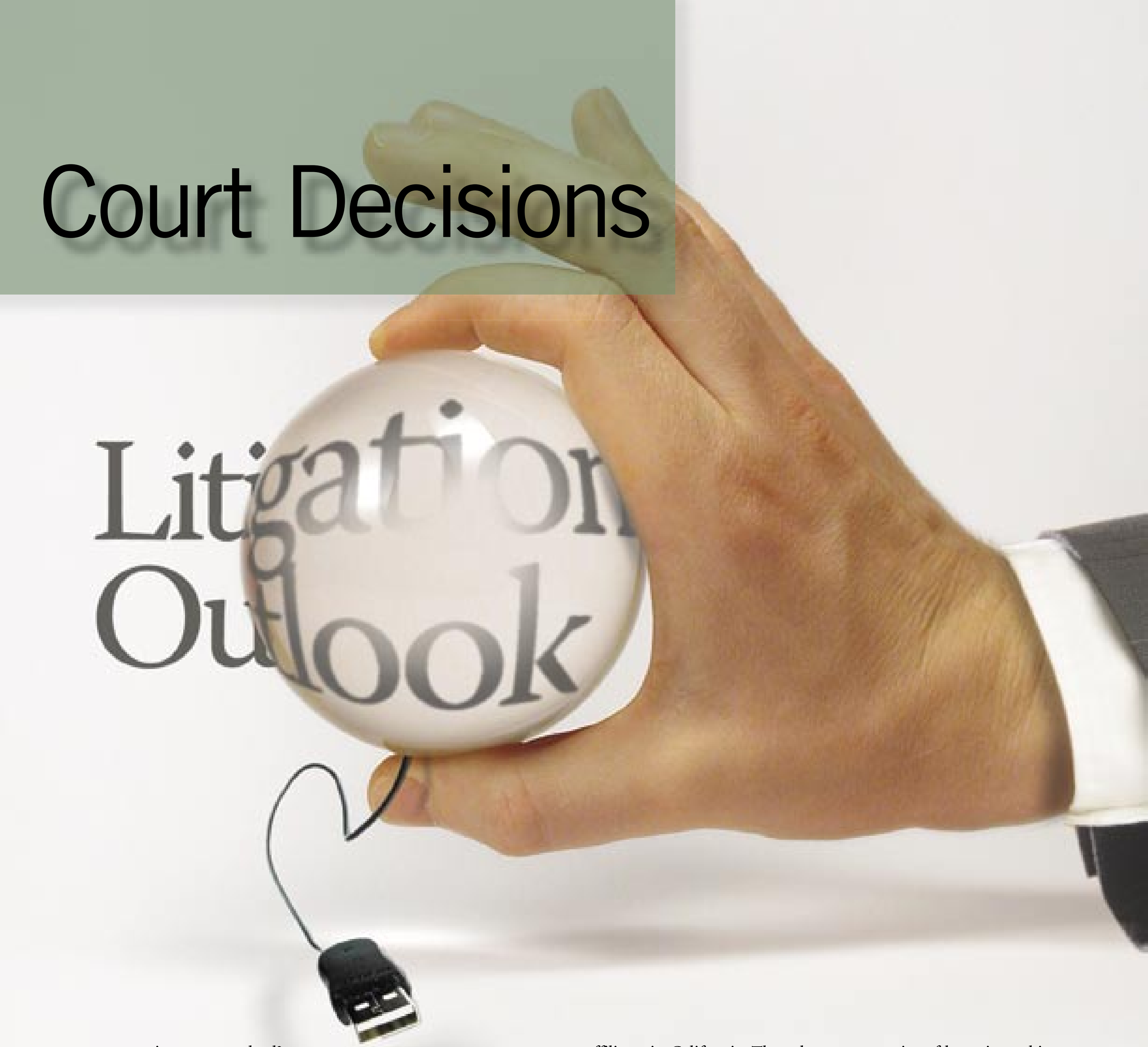
IF ONLY IT WERE THAT EASY

It is a tricky undertaking trying to predict and understand litigation trends in a business as complex as banking, and the potential downside for getting it wrong can be steep. And while we'd all love to have a crystal ball on our desks—digital or otherwise—to help us predict the future, the best way to anticipate and understand the likely issues facing banks in the compliance area is through research, personal experience, and maybe just a touch of hocus-pocus. We've done some of the research part for you here as we have selected four cases that we believe will be ones to watch for 2005.

One issue that is sure to percolate through the industry in 2005 will be efforts to make sense of a recent Supreme Court decision (*United States v. Booker and United States v. Fanfan*) declaring the federal sentencing guidelines unconstitutional. The reason this case presents a compliance issue for bankers is that the guidelines, which federal courts use to calculate criminal penalties, require businesses to maintain "effective" compliance programs to receive reduced sentences. The government revised its federal sentencing guidelines in November 2004, and changes included beefing up the provisions relating to corporate compliance programs.

The Supreme Court struck down as unconstitutional the portions of the statute that made the application of the guidelines mandatory but, somewhat confusingly, left the rest of the system intact. The legal upshot is that the federal sentencing guidelines are now "advisory" and not mandatory. In terms of what the decision means on a practical level, the court's relegation of the guidelines from mandatory to advisory may have some compliance officers wondering exactly what, if anything, they can do to position their banks for favorable treatment. How will the "advisory" application of the federal sentencing guidelines work? Do banks and corporate entities still need to have corporate compliance programs? If so, must they comply with the

Court Decisions



new, more rigorous standard?

After the dust settles and the lower federal courts get comfortable with applying the new "advisory" guidelines, the most likely answer to those questions will be that the court's decision will have little practical impact on the need to have an "effective" compliance program. Under the opinion of the court written by Justice Stephen G. Breyer, the lower federal courts are still expected to calculate the criminal sentence called for under the guidelines, even if they are no longer compelled by law to impose it. Thus, as a practical matter, it is likely that courts will still examine a corporation's compliance program against the standards articulated by the guidelines.

Federal preemption of state law was one of the hot issues for 2004, and it appears that it will remain so in 2005. Peering into our crystal ball, two pieces of litigation stand out as the ones to watch. The first, *American Bankers Association v. Lockyer*, is significant for its potential impact on the ability of banks to share customer information between affiliates in California. The other case, a series of lawsuits seeking to enforce state laws applicable to stored-value gift cards, may prove to be important in shaping the battle lines over a new and profitable product.

The *Lockyer* case is a suit filed by the ABA that seeks to invalidate a California statute, colloquially known as "SB 1." This statute is an attempt by the California legislature to impose restrictions on the sharing of customer information among bank affiliates. These state law restrictions are inconsistent with the federal requirements found in the Fair Credit Reporting Act (FCRA). In April 2004, the ABA and others filed suit in United States District Court, arguing that FCRA preempts SB 1. The district court disagreed, finding that the scope of FCRA was limited to the regulation of "consumer reports," which, in turn, allowed the California legislature to enact a more restrictive "privacy" statute. The ABA promptly appealed the lower court's decision to the United States Court of Appeals for the Ninth Circuit. At press time, the parties were still awaiting a decision.

If allowed to stand, the provisions of SB 1 would affect virtually all financial institutions doing business in California or with California residents. From a compliance perspective, an adverse ruling from the Ninth Circuit would be far-reaching: Banks could be required to develop special rules for handling or sharing information pertaining to California residents. In short, the potential impact of a decision in *Lockyer* could be significant, and while the ABA is optimistic that the court will invalidate SB 1, *Lockyer* should be on your list of cases to watch in 2005.

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We now shift our attention to the East Coast, where a battle is brewing over stored-value gift cards. Two state attorneys general—Thomas Reilly in Massachusetts and Eliot Spitzer of New York—have filed separate actions against Simon Property Group, a property developer that operates a number of shopping malls in the northeastern United States. The gift cards, which retail consumers purchase, may be used at shopping malls operated by the Simon Property Group.

At issue are the substantial fees generated by the cards. The suits allege that the fees generated by the cards violate each state's consumer protection laws. For example, the case filed by the Massachusetts attorney general alleges that Simon Property Group is violating the state gift certificate law by imposing a one-year expiration date on its cards and charging consumers numerous fees that significantly reduce the value of the cards before they expire. Massachusetts officials contend that the charges include a $2.50 dormancy fee that Simon automatically charges after the card has been held for six months, an initial fee to purchase the card, and fees for checking the card's balance or transferring the balance to another card. The suit also alleges that while the state gift certificate law requires gift cards to be redeemable at full face value for seven years, a Simon gift card with a $25 face value is worth only $12.50 after the 11th month, and would expire—be worth nothing at all—after one year. The New York attorney general has filed a similar suit against Simon Property Group based upon New York law that places similar restrictions on gift card fees.

Simon Property Group moved quickly to make federal preemption of the state gift card statutes an issue in the Massachusetts action, with somewhat surprising results. In his suit, the Massachusetts attorney general contends that the state gift card laws were not preempted here, as Simon Gift Cards are not a bank product. Simon Property Group responded with a lawsuit suit of its own, seeking a declaration that the cards are "issued" by Bank of America and, as a result, the National Bank Act preempts state law.

On January 5, 2005, the Office of the Comptroller of the Currency (OCC) weighed in on the issue with a letter to the parties—that it promptly submitted to the federal court—opining that the National Bank Act did *not* preempt state law. The OCC's letter explained that, in its view, the National Bank Act did not completely preempt state law because a federal statute creating an exclusive cause of action had not supplanted the state gift-card statute. The OCC also advised the parties that it did not believe the state law restrictions on fees paid to Simon Property Group were subject to "substantive preemption" by Part 7 (Subpart D—Preemption) of the OCC's regulations, or by the National Bank Act.

The Simon gift card cases are worth watching on several levels. From a compliance standpoint, any institution interested in developing a gift card product must become familiar with applicable state laws. Thirteen states have enacted legislation specifically aimed at gift card- or gift certificate-like products. Moreover, the suits filed by Massachusetts and New York provide a clear indication that as the gift card product grows within the industry, so will the interest from law enforcement and regulators.

The true importance of the case, however, may lie in what it says about the limits of the OCC's willingness to preempt state consumer protection laws. The OCC's January 5 letter, although relatively short in length, is carefully nuanced in its analysis. The OCC's decision hinges upon a tacit acceptance of the proposition that the Simon gift cards are not bank products. If this is true, it sends an important signal to the industry that the OCC may be becoming more selective and less aggressive about the preemption battles it chooses to fight. The conclusion that the Simon gift cards are not bank products provides the OCC a palatable way to avoid taking a political hit for being on the wrong side of a preemption dispute involving a consumer protection statute—at least temporarily. The interesting question—truly one for the Ouija Board—is what the OCC will do if a national bank is sued directly under one of the state gift card statutes. Stay tuned.

Finally, in what may be *the* major litigation issue in 2005 in terms of dollars at risk, the California state appellate courts will address whether a bank may take a setoff for overdrafts or unpaid account fees where the account contains Social Security payments or other government benefits. The case, *Miller v. Bank of America*, presents a state-law challenge to the legal right of Bank of America to automatically debit accounts containing Social Security payments and other governmental benefits for overdrafts and nonsufficient funds (NSF) fees.

On December 30, 2004, the California Superior Court for the County of San Francisco issued a statement of decision ruling that the bank violated state law, including provisions of California's Consumer Legal Remedies Act, Unfair Competition Law, and False Advertising Act. Most observers thought this issue was settled by the federal court system with the Ninth Circuit's decision in *Lopez v. Washington Mutual Bank, FA*. The federal court in *Lopez* rejected similar claims and found that the federal statutes protecting Social Security and supplemental security income benefits from "execution, levy, attachment, garnishment, or other legal process" did not prevent a bank from using these types of funds to satisfy account overdraft charges. *Lopez* also concluded that federal law preempted claims seeking to invalidate the setoffs based upon state consumer protection statutes. The California judiciary has at least temporarily breathed new life into this issue by taking a stance directly contrary to the conclusions reached by the federal appellate court in *Lopez*.

The first and most practical reason to watch this case closely is the impact it could have on overdraft protection and banking operations for institutions with California customers. Several statistics cited by the *Miller* court in its statement of decision emphasize this point: In California alone, 4.3 million individuals—approximately one in eight residents—receive Social Security benefits. In 2003, approximately 1.1 million accounts at Bank of America received direct deposits of Social Security benefits. The trial court's decision has—at least for now—awarded the class plaintiffs (the 1.1 million accountholders) in excess of $1 billion in restitution and damages.

The potential impact of an adverse decision in *Miller* prompted the United States, which is not a party to the litigation, to take the unusual step of submitting a statement of interest to the trial court. The government urged the court to rule that Social Security benefits were properly subject to setoff for overdraft charges and NSF fees, thus raising the specter that a ruling for the plaintiffs may force the banking industry to take steps that could "effectively eliminate or restrict valuable banking services used by Social Security beneficiaries and other recipients of government benefits ...."

From a compliance standpoint, it isn't quite time to panic over the decision in *Miller*. As it stands, the impact of the trial court's ruling is limited to residents of California and hinges on an issue of California law. Observers expect Bank of America to appeal the trial court decision after it becomes final. However, the initial success of the plaintiffs in California may provoke similar suits in other jurisdictions. For example, shortly before the California court issued its decision in *Miller*, a similar depositor suit was filed—and then settled—in federal court in Arkansas (*Hambrick v. First Security Bank*). While the Arkansas court didn't rule on the merits of the issue, it refused to dismiss the case against the bank. In short, if your bank has deposit accounts containing Social Security payments, and you offer overdraft protection or setoff for account charges or NSF fees, you will need to keep an eye on *Miller* as well as your local jurisdictions for any litigation that may pop up.

NOW IT'S 5 PM, *and it's time to start packing up to go home. You bought the crystal ball and the software package from the vendor this morning. After your MIS department hooked it up, you spent the entire afternoon peering into its glassy depths and asking it questions about the future. The results were mixed. You decide to call the vendor.*

"Hey, I seem to be having some problems with that crystal ball you sold me. You know the one with the Internet hookup. I've been asking it questions all day long, but all I get back are messages that I may have already won a free digital audio player or that I can 'Click Here to Get My Credit Score Now.' What's up with that?"

"Oh, we're having some trouble with the spam filter and pop-up blocker on that particular version of the software. You won't have that problem if you buy the available upgrade. We offer a very nice tea leaf reading module as an add-on to the basic crystal ball service."

"Reading tea leaves? Wow, that sounds great! No nasty surprises and I'm assured of staying on top of things. Our regulators are going to love this! I can't wait until our next exam. This whole compliance officer thing is a piece of cake, thanks to you guys! Sign me up, and thanks!"

"No problem. That's what we're here for." BC

About the Author

Greg Taylor *is a recent addition to the American Bankers Association. He brings 17 years' experience as a litigator with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. He serves in the ABA's Office of the General Counsel, where he is responsible for handling the association's litigation efforts.*

Mr. Taylor earned a bachelors degree at the College of William and Mary and is a graduate of the Columbus School of Law at Catholic University. The Washington DC native is an avid cyclist who has raced against Tour de France winner Lance Armstrong. Mr. Taylor also contributes a regular guest column for the online magazine CyclingNews.com. *Reach him at* gtaylor@aba.com.