NORTH DAKOTA BANKERS ASSOCIATION

LEGAL UPDATE

A newsletter covering bank legal and compliance information.

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BANKING REGULATIONS

Circuit Court Upholds Banker's Removal and Fine [6th Cir.]

The banker occupied many prominent positions at the bank where he worked. Under the banker's direction, the bank established a complex loan relationship with a group of related financial entities. The entities, however, stopped paying on their loans because of problems created by the Great Recession. The bank and the entities ultimately restructured their agreement to resolve these issues. The Federal Deposit Insurance Corporation (FDIC) Board investigated and found the restructuring violated the bank's commercial-loan policy. For that reason, the FDIC issued a Notice of Intention to Remove from Office and Prohibit from Further Participation against the banker. An FDIC administrative law judge (ALJ) heard the case and recommended a decision to the FDIC Board. Before the Board reached a decision, however, the Supreme Court decided Lucia v. SEC, 138 S. Ct. 2044 (2018), which held that certain ALJ appointments were unconstitutional. The Supreme Court had held in Lucia that SEC ALJs were officers who must be appointed by the President, a court of law, or a head of department. After that decision, the FDIC Board then newly appointed the same ALJs that had served before without admitting that their previous appointments had been unconstitutional. After the new appointments were made, FDIC Board then remanded the case to a different ALJ. The second ALJ relied on evidence from the prior ALJ's proceedings in finding against the banker under 12 U.S.C. § 1818(e)(1), removing him from banking, and imposing a considerable fine. The FDIC Board adopted the ALJ's recommendations, and the banker petitioned the 6th Circuit Court of Appeals for review of the FDIC's order.

In Calcutt v. FDIC, 37 F.4th 293 (6th Cir. 2022), the court denied the banker's petition. As a threshold matter, the court first determined whether the banker had forfeited his constitutional claims under the doctrine of issue exhaustion because he had not raised those challenges in the proceedings below. Finding no forfeiture, the circuit court explained that because agencies lack the authority to rule on constitutional issues, the banker had not been obliged to bring those issues before the FDIC. The court then considered the banker's three constitutional challenges. First, the banker alleged FDIC Board members' for-cause protections from removal violated separation of powers by interfering with the President's removal power. Second, the banker argued the removal protections afforded to FDIC ALJs similarly offended separation of powers. The court disregarded these first two arguments because the banker could not show the removal protections had harmed him. Furthermore, the court noted ALJs benefited from an exception that granted them heightened protections compared to the protections of Board members. Third, the banker claimed the FDIC infringed the Appointments Clause by not granting him a totally new hearing because his first hearing had been before an improperly appointed ALJ. The banker contended the second ALJ's reliance on the materials from the first hearing undermined his second hearing by not adhering to Lucia. However, the court found the banker's second hearing satisfied Lucia because the only clear requirement from that Supreme Court decision was that a new hearing must take place before a new adjudicator.

The court next turned to the banker's substantive assignments of error. First, the banker argued the ALJ had abused his discretion by denying him cross-examination with respect to certain witnesses' bias. The court circumvented this issue by finding "substantially equivalent evidence" existed in the record to render any such error harmless. Second, the banker claimed the FDIC had failed to satisfy two of the three elements of 12 U.S.C. § 1818(e)(1): the banker had engaged in misconduct and that misconduct had a bad effect on the bank. The court disagreed, holding ample evidence supported the FDIC's findings. Although the court noted the FDIC had failed to articulate that the standard for finding "effect" was "proximate cause," the circuit court found the evidence nonetheless satisfied the statutory requirement. Finally, the banker unsuccessfully argued the FDIC had abused its discretion in levying harsh penalties against him. The court held, however, that the statute clearly authorized the sanctions. One circuit judge filed a lengthy dissent. By Peter Benson pebenson@ttu.edu

Sorry But Overdraft Fees Are Not Interest [10th Cir.]

A customer who had a checking account with a bank overdrew on his account when attempting to make a purchase. The bank, at its discretion, decided to cover the purchase cost and charged the customer an initial overdraft fee, which the customer did not pay. As a result, the bank began charging an extended overdraft fee of $6.50 per business day. The customer went weeks before finally paying the fees on his account. The customer then filed a proposed class action in district court, alleging that the bank's extended overdraft fees qualify as interest under the National Bank Act of 1864 (NBA). If so, the amount charged violates the NBA's antiusury provisions. In response, the bank filed a motion to dismiss under Rule 12(b)(6), arguing that its extended overdraft fees are not "interest" under the NBA and that the customer, therefore, failed to state a claim upon which relief can be granted. In support of its motion, the bank asserted that the interpretation of overdraft fees by the Office of the Comptroller of the Currency (OCC) in its Interpretive Letter 1082 places both initial and extended overdraft fees under 12 CFR § 7.4002(a)'s "deposit account services," not 12 CFR § 7.400l's "interest." The district court granted the bank's motion to dismiss and concluded that the bank's extended overdraft fees are not "interest" under the NBA, to which the customer appealed.

In Walker v. BOKF, NAT'L ASS'N, 30 F.4th 994 (10th Cir. 2022) The court affirmed the lower court's ruling that the bank's extended overdraft charges on a checking account are not "interest" charges within the meaning of the NBA. This case was an issue of first impression for this circuit. Because the NBA does not define the term "interest," the court looked to the OCC's interpretation of the term because the OCC is the agency responsible for administering the NBA. The court found that deference (as explained in Auer v. Robbins, 519 U.S. 452 (1997)) was appropriate in this case because the three criteria of 1. genuine ambiguity, 2. reasonableness, and 3. character and context were all met. Deferring to the OCC's interpretation of "interest," the court looked to Interpretive Letter 1082, which was the OCC's response that directly addressed whether fees charged by a bank in connection with paying an overdraft qualify as "interest" under the NBA. In Interpretive Letter 1082, the OCC concluded that a bank's overdraft fees constituted "non-interest charges and fees" for deposit account services under § 7.4002. Given the OCC's interpretation of overdraft fees as non-interest and the overwhelming majority of other court decisions finding the same, the court ruled in favor of the bank finding overdraft fees are not interest and are therefore not subject to the NBA's anti-usury provisions. By Riley Caraway rcaraway@ttu.edu.

CIVIL PROCEDURE

Beneficiary's Claim That a Bank Credited a Wire Transfer to the Correct Account Number but the Wrong Named Beneficiary Preempted by The Federal Reserve Board Regulation J [4th Cir.]

The originator of a wire transfer correctly identified the account number in the wire transfer but listed another person as the beneficiary. The plaintiff, who is also the beneficiary, sued to recover against its bank, Wells Fargo Bank. The plaintiff sought to hold Wells Fargo responsible for failing to protect the plaintiff from being defrauded by a wire transfer scheme perpetrated by an unknown hacker. The plaintiff also brought a negligence claim against the bank. The district court granted, in part, Wells Fargo's motion to dismiss the plaintiff's claims and its motion for summary judgment. The plaintiff appealed the district court's decision.

In Nirav Ingredients, Inc. v. Wells Fargo Bank, N.A., No. 21-1893, 2022 U.S. App. LEXIS 22449 (4th Cir. 2022), the Fourth Circuit Court of Appeals affirmed the district court's decision and held (i) the district court properly rejected the plaintiff's state law claims when the originator of the transfer had correctly identified the account number in its wire transfer instruction but had listed a hacker as the beneficiary; (ii) the plaintiff's UCC claim had been properly dismissed because the plaintiff's argument that it was the intended beneficiary was foreclosed by N.C. Gen. Stat. § 25-4A-207(b)(1); and (iii) the plaintiff's negligence claim against the bank failed because no reasonable jury would find that the bank's maintenance or lack of oversight of the account proximately caused the plaintiff's injuries. The court reasoned that the plaintiff's state law claims were preempted by the Federal Reserve Board's Regulation J. The court also reasoned that the hacker was the intervening cause and absolved the bank of any liability for mishandling the account. Article 4A of the Uniform Commercial Code (UCC) identifies three parties to a wire transfer--the beneficiary, the originator, and the bank. The court noted that where the account number and name on a wire transfer identify different persons and the beneficiary's bank does not know of this difference, the bank may rely on the account number as the proper identification of the beneficiary of the transfer. N.C. Gen. Stat. § 25-4A-207(b)(l). The court also noted that the UCC provides that if there is a mismatch between the account number and the beneficiary, only the originator has a right to recover against the bank. The court also noted that Regulation J of the Federal Reserve Board, which incorporates Article 4A of the UCC and governs wire transfers, preempts state law. This is because the Federal Reserve needs a uniform and comprehensive national regulation of Fedwire transfers. Therefore, if a bank complies with the federal regulation, any liability founded on state law for negligence or wrongful payment would conflict with the federal regulation and is preempted. On the other hand, the court mentioned that to succeed on a negligence claim, the plaintiff must show that the defendant's breach of duty was a proximate cause of the injury. The court reasoned that the hacker's actions were the proximate cause of the plaintiff's injuries, not Wells Fargo. The plaintiff argued that it was the intended beneficiary because the originator of the transfer intended to pay the transfer to the plaintiff, not the hacker. However, the court reasoned that this argument was foreclosed by the UCC. The court also reasoned that a plaintiff's claim that a bank credited a wire transfer to the correct account number but the wrongly named beneficiary was preempted by Regulation J of the Federal Reserve Board. Thus, the court held that the district court correctly rejected the plaintiffs state law claims regarding the wire transfers and correctly concluded that the plaintiff, who was also the beneficiary, could not prevail on a UCC claim against Wells Fargo. By Love Osemwegie love.osemwegie@ttu.edu.

CONTRACTS

Restatement of Contractual Terms Does Not Qualify as a Replacement of the Original Agreement [5th Cir.]

The district partnered with a construction company to build a new headquarters. The construction company needed a performance bond and consulted the insurance company to provide one. The bond stated that construction contract alterations would not absolve the insurance company of its obligations. The district backed out of the contract before work began and created a new agreement with the construction company. This subsequent agreement did not have the approval of the insurance company. Construction began and eventually stopped before completion due to the construction company's failure. The district attempted to collect their money from the bond; however, the insurance company refused to pay because of the existence of the second agreement. The district sued the insurance company for breach of contract, but the court ruled in favor of the insurance company.

In Harris Cnty. Water Control & Improvement Dist. NO. 89 v. Philadelphia Indem. Ins., 31 F.4th 305 (5th Cir. 2022), the court evaluated the agreement for the construction project and the performance bond section. The court pointed out that the bond contained template language and identified the subject of the bond. The new agreement also had the bond section with the same language; however, it restated some terms. The bond section of the original agreement and the second agreement, however, remained similar. The district contended that the second agreement was merely an amendment to the contract, while the insurance company argued it was an entirely new agreement. Under Texas law, the court found that the second agreement was an amendment of the original. The court relied on language from the Supreme Court of Texas, which only considers material alterations a new contract. The court held that the restatements made the second agreement a mere amendment to the original and not a replacement. Accordingly, the insurance company was liable on the bond. By Avery Bertagna abertagn@ttu.edu.

LABOR & EMPLOYMENT

No Overtime Pay for Mandatory Work Free Mealtimes on Airplanes [5TH CIR]

The government used a security company to monitor detainees during flights both domestically and abroad. The security company employees objected to a compensation policy during return flights they made after dropping off detainees in foreign countries. The policy that the security employees had a problem with automatically deducted an hour of pay for mealtimes on these return flights. The mandatory rule contained a couple of exceptions. If detainees remained on board for the flight, there would be no deduction. Additionally, If the return flight did not exceed 90 minutes, there would be no deduction. The security employees alleged that this violated the Fair Labor Standards Act (FLSA). The employees were no longer employed by the security company, but they had been nonexempt hourly employees during their work. The security employees across the country brought both individual suits and class actions against the security company for this policy. The employees claim that the meal period violated the FLSA because they were entitled to a minimum wage that they did not receive. Additionally, they claim the denial of overtime wages violated the FLSA. The security employees appealed a judgment in favor of the security company.

In Dean v. Akal Sec., Inc., 3 F.4th 137 (5th Cir. 2021), the court considered the claim for a violation of the FLSA and the request for overtime compensation. The court evaluated the arguments in two parts: whether the return flight is compensable travel time and whether the circuit's predominant-benefit test meant an uncompensated work time had occurred. The court determined that regulations and prior caselaw do not create any bars to a non-compensable mealtime on airplane flights. The court then looked at the security company and its application of this rule. The benefits test evaluates whether the employee or the employer received the predominant benefit from the mealtime. The court determined that despite the employees not being able to leave the worksite or use their phones during the break, the time did not result in a benefit to the security company. Only the security employees benefitted from the mealtime. Therefore, the court determined that the automatic deduction did not violate the FLSA, and the break passed the predominant-benefit test. By Avery Bertagna abertagn@ttu.edu.

LENDING

Lender Triumphs Over Guarantor, and Proves Its Ownership of Note and Guaranty Agreement [Tex. App.]

On August 10, 2018, the LLC executed a promissory note in favor of the Partnership with a maturity date of December I of the same year. A managing member of the LLC (hereinafter "Guarantor," together with LLC and the Partnership collectively, the "Parties") also signed onto the note as a personal guarantor. The Parties later modified the note and extended the maturity date to October 1, 2019 (the "Maturity Date"). The LLC defaulted on the note, and the Partnership accelerated the debt and demanded payment. ln December of 2019, the Parties entered into a forbearance agreement in which the Partnership agreed to refrain from exercising its remedies under the original default. The LLC defaulted again, and the Partnership sought payment from the Guarantor. When the Guarantor failed to pay, the Partnership sued him for breach of the guaranty. The Partnership moved for summary judgment, arguing that it was entitled to recover on the note as a matter of law. In response, the Guarantor contended that the Partnership had failed to establish its rights, specifically its ownership of the guaranty and underlying note, and that the Partnership's calculation of interest was conclusory. The district court granted summary judgment to the Partnership, and the Guarantor appealed.

In Bran v. Rod De Llano Fam. P'ship, L.P., No. 14-21-00577-CV, 2022 Tex. App. LEXIS 6039 (Tex. App-Houston [14th Dist.], Aug. 18, 2022, no pet h.) (mem. op.), the court held that because the Partnership was the note's original payee, and it did not assign or otherwise transfer the notes, it proved its present ownership of both the note and the guarantee. Moreover, it held that the note conclusively provided the applicable interest rate, and the district court did not include unawarded attorney's fees in its interest calculations for damages. First, the court determined the ownership of the note and guarantee. In the Guarantor's appeal, he had argued that the Partnership failed to prove it is the present owner of the note and guaranty: despite the Partnership having owned the note and guaranty at the time of the execution, it could not prove that it remained the owner at the time of the suit. The Partnership submitted an affidavit from its president and sole member who was personally involved with the signing of the note and the guaranty agreement. The attached note and guaranty identified the Partnership as the lender, the LLC as the borrower, and the Guarantor. Therefore, summary judgment was appropriate. Regarding the interest rates, the court held that a lender is not required to 'file detailed proof of the calculations reflecting the balance due on a note...." Bran v. Rod De Llano Fam. P'ship, L.P., No. 14-21-00577- CV, 2022 Tex. App. LEXIS 6039, at *3 (Tex. App.-Houston [14th Dist.], Aug. 18, 2022, no pet. h.). The Guarantor failed to contest any of the numbers presented by the Partnership, and the interest rate of the note was authorized under Texas law. By Miguel Escobar Miguesco@ttu.edu.

*Bank Failed to Establish Justifiable Reliance on False Information Provided by Accounting Firm [Tex. App.]

The debtor operated automobile dealerships. Automobile dealerships typically enter into floor-plan financing agreements in which a lender provides a short-term loan to the retailer for the purchase of inventory. As the inventory is sold, the retailer repays the lender. This type of arrangement allows the dealer to finance the purchase of large ticket inventory items, with the inventory serving as collateral should the retailer default. Typically, a floor-plan financing agreement requires periodic repayment of the loan as inventory is sold. The sale of inventory without making the required loan payments is referred to as the selling of inventory "out-of trust." The debtor entered into a floor plan agreement with the bank. Both the bank and debtor employed auditors to conduct audits periodically. Relevant here, the accounting firm employed by the debtor conducted audits of its consolidated balance sheets in the 2015 and 2016. The 2015 Audit Report excluded both income and cash flow statements. Neither the 2015 nor 2016 audits discovered evidence of fraud. Before publication of the 2016 Audit Report, an auditor employed by the bank conducted an audit of its own, the 2016 Unqualified Audit Report. This audit revealed that the debtor had engaged in out-of-trust sales totaling over $25 million. However, the bank's auditor did not inform the bank of the out-oftrust sales at this time. Thus, the bank and debtor entered into an additional series of loan agreements. In determining whether to approve the loans, the bank prepared a loan memorandum analyzing the following factors: (1) the ability of the debtor to repay the loans, using numbers provided exclusively from non-audited financial statements prepared by the debtor; (2) the financial resources of the guarantors, the owners, using personal financial statements and tax returns of the owners as well as unaudited financial statements of each dealership, prepared by the debtor; and (3) the nature and extent of collateral that could be liquidated in the event of default by the debtor, using a collateral valuation summary prepared by the bank. Although the debtor provided the 2015 Audit Report to the bank before it finalized the loan agreements, the report did not form a basis of the bank's analysis. Without reviewing the 2016 Audit Report, the bank subsequently approved increases on each of these loans. The debtor ultimately filed for Chapter 11 bankruptcy, prompting the bank to seek to recover sums due by suing the accounting firm employed by the debtor. Although the bank argued that it relied on misstatements and omissions contained in the 2015 and 2016 Audit Reports, the trial court granted summary judgment in favor of the accounting firm.

In Int'/ Bank of Commerce v. Lane Gorman Trubitt, No. 07-21-00163-CV, 2022 Tex. App. LEXIS 5504 (Tex. App.- Amarillo Aug. 3, 2022, no pet. h.), the court upheld the decision of the lower court because the bank failed to provide evidence sufficient to establish that it justifiably relied on false information provided by the accounting firm. To prevail on its negligent misrepresentation claims for the 2015 Audit Report of the balance sheet only as well as the 2016 Audit Report, the bank had to establish that each report contained false information intended by the accounting as guidance for others, that the bank belonged to a specified class or group that the accounting firm knew would receive and reasonably rely on the audits, that the bank in fact reasonably relied on that information, and that its reliance thereon caused the bank damage. However, the evidence instead indicated that the bank approved the loans based on figures provided by the debtor, not the accounting firm, while the figures for cash flow, guarantor assets, and value of the real estate collateral were derived from documents produced in-house and not audited by the accounting firm. Thus, the bank failed to establish that it justifiably relied on either the 2015 or 2016 Audit Reports. By Brooke Allen brooke.n.allen@ttu.edu.

SECURITY INTERESTS

*Because Article 9 Applied, Bank's Perfected Security Interest Prevailed [Tex. App.]

The consignor in this case manufactured computer tablets for resale by consumer retailers. To list products on the website of one consumer retailer, the consignor agreed to use an approved third party to fulfill the orders and ship the products to the consignor's customers. Thus, the consignor entered into a Fulfillment Services Agreement (FSA) to that effect with the consignee. Under the two agreements, the consumer retailer agreed to pay the consignor for the products shipped by the consignee and the consignor agreed to pay a fee to the consignee for each product it shipped. However, in practice, the consumer retailer sent payment for the products to the consignee rather than to the consignor. The consignor failed to perfect a security interest in either of these accounts. The same year, the consignee borrowed money from a bank, granting the bank a security interest and lien on its assets. Subsequently, the consignee defaulted and agreed to surrender all of its cash inflows to the bank, including a cash collateral account controlled and maintained by the bank. Because the consumer retailer sent payment for the products shipped to the consignee rather than to the consignor, the consignor never received payment for its products; the payments by the consumer retailer were deposited into the consignee's cash collateral account at the bank and applied to the repayment of the consignee's loan. The consignor thereafter sued both the consignee and bank to recover funds owed. After the consignor nonsuited its claims against the consignee and the court ruled in favor of the bank, this appeal followed.

In Mingtel Inc. v. Comerica Bank, No. 05-20-01115-CV, 2022 Tex. App. LEXIS 5449, 2022 WL 3040636 (Tex. App.- Dallas Aug. 2, 2022, no pet. h.) (opinion not yet released for publication), the court considered whether Article 9 of the UCC applied, thereby governing the transaction, or whether a "true consignment" existed between the consignor and consignee. If the Article 9 did not apply, the funds sent by the consumer retailer to the consignee did not constitute the "cashflow" of the consignee in which the bank held a security interest. On the other hand, if Article 9 did apply, the bank's perfected security interest had priority over the consignor's unperfected security interest. A transaction in which a person delivers goods to a merchant for the purpose of sale constitutes a "consignment" under § 9.102(a)(20) of the Texas Business and Commerce Code if, among other requirements, the merchant "is not generally known by its creditors to be substantially engaged in selling the goods of others." As explained by a comment to § 9.319, the creditor of a consignee with a perfected security interest in the consigned property prevails over the unperfected security interest of a consignor. Thus, the consignor argued that Article 9 did not apply because the bank generally knew of the consignee's business ventures. However, the evidence presented by the consignor proved insufficient. Although the FSA clearly stated that the consignee engaged in the selling of others' property on consignment, the bank's file on the consignee did not contain the FSA. Similarly, while the consignor next pointed to testimony of an officer of the bank, revealing that the bank looks into "what the business actually does" when an entity requests a line of credit, the testimony lacked any indication that the bank was generally aware that the consignee was in the business of selling the property of others on consignment. Thus, the court ultimately held that Article 9 applied; therefore, the bank's perfected security interest in the consignee's accounts had priority because the consignor failed to perfect a security interest in the consigned goods. By Brooke Allen brooke.n.allen@ttu.edu.

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Tracy Kennedy
NDBA General Counsel

Role of NDBA General Counsel

NDBA's general counsel serves as the attorney for the association. Although Tracy is pleased to be able to serve as a resource for NDBA members in responding to their questions, she is providing general information, not legal advice. Banks must obtain legal advice from counsel who has been retained by the bank to represent the bank's interests in a specific matter.

To contact Tracy Kennedy, NDBA General Counsel, call 701.772.8111 or email at tracy@ndba.com.