

LEWIS RICE *Bank Law Update*

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Court Blocks Anti-Competitive Terms of Participation Agreement

A recent New York District Court opinion suggests that a borrower may, in certain circumstances, block particular terms of a lender's sale of a participation in the borrower's loan, even if the loan agreement does not require the borrower's consent. In *Empresas Cablevisión v. JPMorgan Chase Bank* (2d Cir. 2010), an appellate court upheld portions of a New York district court's preliminary injunction on behalf of a borrower to block certain terms of the sale of a participation in the borrower's loan to the borrower's competitor.

In *Empresas*, the parties' credit agreement required the borrower's consent for the sale of an assignment, but the sale of a participation in the loan did not require the borrower's consent if both the primary relationship between the borrower and lender and the lender's rights and obligations remained unchanged. The lender initially requested the borrower's consent to the assignment of 90% of the loan to a bank affiliated with one of the borrower's primary competitors. The borrower refused to consent to the assignment, and indicated its belief that a grant of participation would violate the lender's duty of good faith. Despite the fact that the borrower refused to consent, and that other interested purchasers who were not competitors of the borrower existed, the

The Dodd-Frank Act and Federal Preemption of State Banking Laws

In the months following passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, many banking industry observers, particularly consumer advocates, viewed the Dodd-Frank provisions limiting federal preemption of state banking laws as a rebuke of prior Comptroller of the Currency preemption positions and a rollback of OCC preemptive authority. However, new OCC rules and interpretive guidance, and recent federal court decisions, illustrate a growing view that Dodd-Frank did little to change the basis for OCC preemption authority. While this may be good news for national banks and federal thrifts, the controversy over the breadth of federal banking preemption after Dodd-Frank has not yet settled, and national banks and thrifts should not simply assume that state consumer protection or similar laws cannot apply to them.

The Dodd-Frank Changes. Dodd-Frank made a number of changes in the availability of federal preemption to national banks and federal thrifts. Section 1044 of Dodd-Frank contains provisions that affect the scope of preemption for the operating subsidiaries of federal savings associations and national banks and set forth procedural requirements for future OCC preemption determinations. (Also, Dodd-Frank Section 1047 codifies the Supreme Court's *Cuomo v. Clearing House Association* decision on "visitorial powers," providing that no provision of federal banking law on visitorial powers will restrict the authority of state attorneys general—or other chief law enforcement officers—to bring an action against a national bank.) The preemption provision that has generated the most controversy, however, appears to be the Section 1044 requirement that "state consumer financial laws" may be preempted only if: (1) application of such a law would have a "discriminatory effect" on national banks compared with state-chartered banks; (2) "in accordance with the legal standard for preemption in the decision of the Supreme Court in *Barnett Bank of Marion County, N.A. v. Nelson*," the state consumer financial law "prevents or significantly interferes with the exercise by the national bank of its powers"; or (3) the state consumer financial law is preempted by a provision of federal law other than the National Bank Act. "State consumer financial laws" are state laws that do not directly or indirectly discriminate against national banks and that directly and specifically regulate the manner, content, or terms and conditions of any financial transaction or related account with respect to a consumer. Dodd-Frank does not address the application of state law that is not a "state consumer financial law" to national banks.

The OCC Position. In its pre-Dodd-Frank preemption regulations, the OCC had concluded that federal law preempts state laws that "obstruct, impair or condition" a national bank's ability to fully exercise its federally authorized powers, citing state laws on licensing or registration and on the terms of credit and disclosure as examples of laws that do not apply to national banks under this general standard. In May 2011, the OCC released a proposal to amend its regulations on preemption of state law powers to conform those rules to Dodd-Frank. The OCC also released a letter to Senator Tom Carper (D-Del) in which it elaborated on its interpretation of the Dodd-Frank preemption provisions.

In the proposal and in the Carper letter, the OCC stated that the preemption standard it applied when issuing its 2004 regulations was consistent with the preemption standard under Dodd-Frank,

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leading to the OCC's conclusion that Dodd-Frank did not overturn the prior preemption regulation. In the OCC's view, the "conflict preemption" standard under the *Barnett* provision of Section 1044 (clause (2) above) is not limited to a state law that "prevents or significantly interferes with exercise by a national bank of its powers" (the phrase included in Section 1044); rather, the preemption analysis must consider the whole of the conflict preemption analysis in the *Barnett* decision. Ultimately, the OCC concluded that since Dodd-Frank preserved the *Barnett* conflict preemption standard, precedents consistent with that analysis—which may include regulations adopted consistent with such a conflict preemption justification—are also preserved.

Under this standard, most, if not all, of prior OCC preemption determinations would remain in effect, with the result that the state laws so preempted would continue not to apply to national banks.

Despite significant controversy, including an opposing comment letter from the Treasury Department's general counsel, in July 2011 the OCC adopted its proposal in final form essentially unchanged. In adopting the final rule, the OCC reiterated its conclusion that Dodd-Frank did not create a new "prevents or significantly interferes" preemption standard independent of prior federal preemption law; instead it incorporated the conflict preemption legal standard and the reasoning that supports it in the Supreme Court's *Barnett* decision. The OCC also confirmed its views that since Dodd-Frank preserved the *Barnett* conflict preemption standard, precedents consistent with that analysis—including regulations—are also preserved. Finally, the OCC confirmed its view that the procedural requirements applicable to an OCC determination that a state consumer financial law is preempted apply prospectively and do not invalidate prior precedent.

Court Decisions. Since Dodd-Frank was enacted only slightly more than one year ago, there has been limited opportunity for courts to interpret the Dodd-Frank preemption provisions. However, what decisions there are tend to support the OCC view. In *Baptista v. JPMorgan Chase Bank* (11th Cir. 2011), the first appellate ruling on preemption following passage of Dodd-Frank, the court upheld preemption of a Florida statute prohibiting banks from settling "any check drawn on it otherwise than at par." After deciding that the Florida law met the definition of a "state consumer financial law," the court ruled that, following Dodd-Frank, the proper preemption test is whether there is a "significant conflict between the state and federal statutes." The court held that

the Florida statute was in "substantial" and "irreconcilable" conflict with the National Bank Act, because the state law barred an activity that the National Bank Act specifically authorized, and so was preempted. The OCC cited the *Baptista* decision when it released its preemption regulation in final form. More recently, in *U.S. Bank, N.A. v. Schipper* (S.D. Iowa 2011), which involved the applicability of Iowa payment processing rules to a national bank, a federal district court considered an argument that Dodd-Frank "raised the standard" for preemption. The court concluded that Dodd-Frank did not materially alter the standard for pre-emption that the court must apply in the case. (The decision, however, did not analyze whether the state law in question was a "state consumer financial law.")

Going Forward. The full impact of Dodd-Frank on future preemption determinations remains to be seen. Certainly, Dodd-Frank did make changes. The removal of federal preemption for national bank and federal thrift operating subsidiaries may significantly change bank and subsidiary operations (e.g., banks with operating subsidiaries engaged in regulated activities, such as consumer lending, may wish to consider taking those activities back into the bank). The scope of federal preemption as it applies to federal thrifts has been narrowed, and the OCC is now required to implement additional procedures and create a formal record before making preemption determinations. However, from the OCC's rulemakings and early judicial decisions, it appears that the substantive law of federal preemption as it applies to national banks and federal thrifts will be found to be unchanged in many important respects. The reasoning underlying the OCC rules and the *Baptista* and *Schipper* decisions has not been fully tested, though, nor is there great clarity in what types of state laws would be subject to any additional Dodd-Frank preemption standards. National banks and federal thrifts confronting a state law that raises preemption issues should consult with counsel before either ignoring, or complying with, that law.

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lender nevertheless granted a 90% participation to the affiliate of the borrower's competitor.

The district court's decision to grant an injunction was primarily based on the fact that the participation agreement allowed the participant, an affiliate of one of the borrower's primary competitors,

to request and receive nearly unlimited information about the borrower's business. The court also weighed other terms of the participation agreement, including the fact that in the event of the borrower's default, which was defined broadly, the participation agreement would become an assignment and the participant would become the lender. Further, the agreement provided that the participant would receive not only 90% of the borrower's payments and interest, but 90% of the fees earned by the lender under the agreement. Finally, the agreement gave the participant the right of first refusal for the remaining 10% of the loan.

The court held that the lender had, in fact, breached the implied covenant of good faith and fair dealing, despite the fact that it likely had not breached an express provision of the contract, and ultimately found that the participation agreement was a circumvention of the borrower's refusal to consent to the assignment. The court then issued a preliminary injunction enjoining the lender from proceeding with the participation agreement. On appeal, the appellate court affirmed the preliminary injunction, but ordered the district court to modify the injunction to prohibit only the exercise of rights under the participation agreement that put the borrower at a competitive disadvantage. In essence, the appellate court required the parties to reform the participation agreement to remove the unfair terms, but left the majority of the agreement intact.

All syndicated loan agreements (and many non-syndicated loan agreements) provide for the sale of the loan by assignment or by grants of participation in the loan. Typically, parties can look to and rely on the express terms and conditions of their contractual agreement to determine whether the lender's sale of an assignment or participation in the loan is permitted. The lender rarely owes fiduciary duties to the borrower, however all contracts contain an implied covenant of good faith and fair dealing. The implied covenant is difficult to breach without there also being a breach of an express provision of the contract.

It is important to note that the facts in *Empresas* were particularly sympathetic to the borrower, given that the participation was assigned to an affiliate of its primary competitor. *Empresas* suggests, however, that lenders participating in the secondary loan market should be aware that actions taken with respect to loan agreements may be examined not only for compliance with their express terms, but also in light of the implied covenant of good faith and fair dealing.

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Court Upholds “Reasonable Promptness” Standard from Deposit Account Agreement

In *Napleton v. Great Lakes Bank* (Ill. App. 2011), an Illinois Appellate Court dismissed a bank customer's claim for reimbursement of money withdrawn from his account when the bank honored a forged check. The customer failed to give the bank notice of the fraud within the time period set forth in the deposit account agreement between the bank and the customer. Section 4-406 of the Illinois Uniform Commercial Code (UCC) places a duty on customers to examine their bank statements with “reasonable promptness” and promptly notify the bank of any unauthorized payment, or the customer may be precluded from asserting a related claim against the bank. The court reasoned that while the relationship between bank and customer is generally governed by the UCC, the parties may vary the effect of the UCC's provisions by mutual agreement. In this case, the account agreement effectively defined “reasonable promptness” as 30 days, and thus, the customer's failure to notify the bank of the unauthorized payment within that time period precluded his claim against the bank for honoring the forged check.

In *Napleton*, the customer requested that the bank reimburse his account for \$7,500.00, the amount of a forged check drawn on the account. The account agreement between the customer and the bank required the customer to “examine [the customer's] statement with ‘reasonable promptness’” and provided that, if the customer did not notify the bank of any unauthorized signatures, alterations or discrepancies within 30 days after the statement was mailed, the customer would have no claim against the bank. The \$7,500.00 debit for the forged check appeared on the customer's November 2007 statement, but the customer did not report the issue to the bank until March 2008, when he requested a credit. Because the customer failed to inform the bank of the forgery within the 30-day period, the bank refused the customer's request for reimbursement.

The customer sued the bank alleging breach of contract and conversion. The trial court dismissed the customer's case, citing the 30-day notice provision. On appeal, the customer contended that the case should not have been dismissed because, under the UCC, the bank was required to prove that it suffered a loss as a result of the customer's failure to provide timely notice of the forgery.

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Section 4-406 of the Illinois UCC states that, along with providing an account statement, a bank must provide the customer with the original checks paid, make the checks available to the customer, or provide the customer with sufficient information to allow the customer to identify the checks paid (i.e., the check number, amount and date of payment). Section 4-406 places a duty on the customer to “exercise reasonable promptness” in examining the statements and notifying the bank of any unauthorized payment that the customer should reasonably have discovered. A customer is precluded from asserting a claim against the bank for an unauthorized signature if the customer does not comply with this duty, provided the bank also proves that it suffered a loss by reason of the customer’s failure to do so.

In *Napleton*, the customer argued that the bank had failed to demonstrate, as required by Section 4-406, that it suffered a loss because of the customer’s failure to notify the bank of the forgery within the 30-day period. The court cited Section 103(a) of the UCC, which states that the effect of UCC provisions may be modified by the parties (subject to certain limitations), and found that the terms of the account agreement superseded the Section 4-406 requirement. The account agreement provided that the customer must examine the account statement with reasonable promptness, and that the customer would have no claim against the bank if he did not notify the bank of an unauthorized payment within 30 days after the statement was mailed. Because the customer failed to notify the bank of the discrepancy within the 30-day period, the court held that he was precluded from bringing the claim, regardless of whether the bank demonstrated it had suffered a loss because of the customer’s failure to provide such notice.

The court in *Napleton* affirmed that while the UCC shapes the basic relationship between a bank and its customer, the parties have the freedom and flexibility to define the specific terms of their relationship, including terms that vary the effect of certain UCC provisions. *Napleton* provides Illinois banks some assurance that their customer account agreements will be enforced on their terms, and, because Illinois has adopted a version of Section 4-406 essentially unmodified from the model UCC, its holding may be instructive in other states.

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