FW FarleighWitt Attorneys

# Credit Union Executive News

December 22, 2006

## NEW ELECTRONIC RECORDS RULES

Over the last decade our world has changed from a document world to a digital world. Through technology, documents and document storage issues have been replaced by electronic records and data security concerns. However, in many areas the law has not kept pace with technology and we frequently get stuck in legal gridlock. For example, not until the E-SIGN Act removed the legal barriers to electronic contracts and signatures could Credit Unions efficiently deliver financial products and services online.

Outdated legal rules have frustrated litigation attorneys as well. Trial lawyers increasingly haggle over gaining access to or preventing access to electronic data for use as evidence in litigation, hung up on the scope of "documents" in subpoena or discovery requests. Now even the litigators have found common ground by updating the federal procedural rules for the discovery and production of electronic data that make sense in today's digital world.

On December 1, 2006, amendments to the Federal Rules of Civil Procedure ("FRCP") concerning the discovery of electronically stored information ("ESI") went into effect. The rules require businesses, including Credit Unions, to preserve electronic documents and data that directly relate to an actual lawsuit or one that is reasonably likely to occur.

*Cont. p 2*

## 2006 COMPLIANCE RECAP AND OUTLOOK

This year has brought the usual, steady flow of new legislative and regulatory requirements for Credit Unions. We wanted to recap some of the significant federal developments of 2006 along with the resulting compliance requirements for your Credit Union, followed by our brief outlook for 2007.

**2006 Recap**

**January: Reg. E. Electronic Check Transactions Amendments** – New rights and responsibilities for parties handling electronic check transactions effective January 1, 2007. *Impact:* Credit Unions must update EFT agreements for electronic check transaction unauthorized use liability.

**March: FACTA** – Medical Information final rule. *Impact*: Credit Unions must develop and adopt policies and procedures to address disclosure of medical information.

**April: NCUA – revised Model FCU Bylaws** – NCUA revised and updated

*Cont. p 3*

*Inside this issue:*



**SEASONS GREETINGS FROM FARLEIGH WITT**

On behalf of the attorneys, paralegals and staff at Farleigh Witt, we thank you for your business and for allowing us to be your trusted partner. We feel truly blessed to serve such great clients as our Credit Union clients. We hope our Credit Union Executive Newsletter has been a valuable resource to you and your staff this year and will continue to provide insights and helpful guidance in 2007.

**Merry Christmas and Happy New Year!**

## ELECTRONIC RECORDS (CONT.)

**The Importance for Credit Unions**

As Credit Unions implement electronic storage of all records and data, the new rules will have a significant operational impact. Credit Unions will need to update records management policies and procedures to assure appropriate handling of electronic information that may be subject to discovery as serious sanctions can be imposed and exposure arise from a Credit Union's failure to preserve ESI.

One of the key areas where new policies and procedures will be needed is data deletion and document destruction schedules. Once the Credit Union receives a notice of a lawsuit, the Credit Union must place a "litigation hold" on all of its records, including ESI. Once the litigation hold is in place, Credit Unions must actively monitor to ensure that related records are not subsequently destroyed or deleted.

**Summary of FRCP Electronic Records Rules**

The FRCP lays out rules that are applied in civil cases in federal courts. Many states model their civil trial rules on the FRCP, so it is widely anticipated that these federal rules will become state law too. The FRCP changes provide more detailed guidelines on how a party in litigation must handle their documents and information stored as electronic records in order to comply with document discovery and production requests. The following are the key rule changes that Credit Unions should understand:

- **Discoverable Information Expanded** – Document discovery will now automatically reach any and all relevant ESI, which includes any type of information that can be stored electronically. The new rules will require litigating parties to search for discoverable material in multiple electronic document formats and types in order to determine all potentially relevant and privileged information before producing that data. The challenge for Credit Unions and their attorneys is recognizing that ESI comes in many formats and is usually not centrally managed. For example, the Credit Union's ESI includes: files and data on staff PCs, file servers, email and voicemail systems, PDAs, cell phones, back up disk drives and CDs and even obsolete computer equipment and media (floppy disks, back up tapes, etc.) stored by the Credit Union.

- **Early Attention to E-Discovery Issues** – Significant work must be done to identify and produce relevant documents in the initial stages of litigation. The amendments require litigating parties to address electronically stored information early in the discovery process. For example, parties must develop a discovery plan that resolves issues relating to the discovery of ESI – including the form or forms in which it will be produced.

- **Safe Harbor Rule –** The amendments provide a safe harbor for inadvertent destruction of a potentially relevant document, despite "good faith efforts" to maintain and comply with a records retention program. This is significant if a Credit Union has developed comprehensive records retention and destruction policies and procedures. If it can be proven that a well-developed system is in place, the courts will be more tolerant of the accidental deletion of some documents. However, Credit Unions should ensure that ESI subject to automatic destruction is preserved once litigation is ongoing or is reasonably anticipated. It is important to note that these safe harbors are not yet tested and are not intended to protect companies that simply fail to get around to compliance. Credit Unions should begin to develop practical policies and procedures to comply with the new rules. Failure to be proactive could result in costly forensic IT expert fees, monetary penalties, a directed verdict, or an adverse jury instruction, or other sanctions that courts can impose.

The revised rules make all parties to litigation in federal courts more accountable for preserving and accessing electronic data for discovery requests. Failure to follow the new rules will likely be a costly mistake, possibly resulting in longer, more expensive discovery requests, unnecessary and costly settlements of frivolous litigation, and even lost cases and fines. Credit Unions should consult legal counsel with questions about ESI and the scope of litigation hold procedures that would be appropriate for when the duty to preserve electronic

*Cont. p 3*

## ELECTRONIC DISCOVERY (CONT.)

information arises. Before you get hit with a discovery demand that seeks "every staff email created, sent, received, deleted, past, present and future, blah, blah, blah…" let us help you work on the policies and procedures to properly respond to such outrageous requests.

*Chris Parnell and Brian Witt*

## COMPLIANCE RECAP (CONT.)

its model Bylaws for FCUs. *Impact*: Totally optional, study the changes and our November article on Bylaw pitfalls before adoption.

**July: NCUA – Disaster Preparedness and Response Examination Procedures** (NCUA Letter No. 06-CU-12) **–** NCUA issued new exam guidelines for reviewing Disaster Recovery Policies. *Impact:* provides guidance for drafting or updating policies.

**NCUA – Third Party Servicing of Indirect Vehicle Loans** (NCUA 701.21(b)) – NCUA issued a final rule on Credit Union purchases of indirect vehicle loans serviced by third parties. *Impact*: further restrict Credit Union purchases of indirect vehicle loans serviced by third parties such as Centrix.

**FACTA – Proposed Address Reconciliation Rule and Red Flag Identity Theft Rule** – The comment period ended in September and final rules are expected in 2007. *Impact*: Credit Unions must develop and adopt policies and procedures for address reconciliation and red flag identity theft events. *(Call Farleigh Witt regarding our FACTA Compliance Program and Policies*).

**August: FFIEC Guidance for Authentication in an Internet Banking Environment (**NCUA Letter to Credit Unions 06-CU-13) **–** clarifies guidance requiring Credit Unions to conduct a risk assessment and implement multi-factor authentication, if necessary by year end 2006. *Impact:* Risk assessment documentation should be done by now.

**September: Financial Services Regulatory Relief Act** – Increased loan terms and added nonmember services for FCUs and revised PCA net worth. *Impact*: Very little.

**Reg E. Payroll Cards Amendments** – FRB's final rule providing guidelines of the rights and responsibilities of the Credit Union employer and employee for payroll cards. *Impact:* Credit Unions will need to provide cardholder disclosures to the extent payroll cards are offered.

**October: National Defense Authorization Act -** Added new consumer protections and disclosures on credit extended to service members and dependents including, a 36% rate cap. *Impact:* Very little if you do not make high cost loans to members in the military or engage in prohibited lending practices.

**FFEIC Interagency Guidance on Nontraditional Mortgage Product Risk (**NCUA Letter to Credit Unions 06-CU-16) **–** FFEIC guidance discusses prudent underwriting, risk management practices and consumer disclosures for nontraditional mortgage loans. *Impact*: NCUA will expect compliance with this guidance on interest only, payment option, or other similar loans.

**November: NCUA Share Insurance Official Sign -** New NCUA sign and logo revised effective *Impact*: Revise all signage (branches, print, website, etc.) by May 22, 2007.

**December: NCUA Bank Conversion Rules -** NCUA added new requirements for Credit Unions considering a bank conversion including increased disclosures, voting procedures and member communications. *Impact*: Increases the disclosure and voting requirements for Credit Union/bank conversions but does not stop them.

**Electronic Records Rules (Federal Rules of Civil Procedure)** – Adopted in December 2006 – requires Credit Unions to preserve electronically stored information (ESI)

*Cont. p 4*

## COMPLIANCE RECAP (CONT.)

related to litigation claims (see related article in this newsletter). *Impact*: Credit Unions need to update their policies and operational practices on records preservation.

**December:** **Department of Defense (DOD) – Limitations on Terms of Consumer Credit Extended to Service Members and Dependents** – Proposed loan and disclosure rules. Comments Due February 5, 2007.

**2007 Outlook**

2007 should (in theory at least) bring the final round of FACTA regulations. We also expect that there will be additional data security protections adopted at both the federal and state levels. One recent trend we have seen from state and federal Credit Union regulations is the use of "guidance" to establish regulatory requirements and expectations rather than providing notice and public comment to shape such regulations. Unfortunately we expect this trend will continue in 2007.

*Brian Witt*

## BANK OF AMERICA SAVES $1.5 BILLION—CREDIT UNIONS CAN BREATHE EASIER

Several years ago, the U.S. Court of Appeals for the Ninth Circuit created a stir among west coast financial institutions when it ruled that direct deposits of social security benefits and other exempt funds could not be applied against overdrafts and overdraft fees in the account receiving the direct deposit (*Lopez v. Washington Mutual*). Fortunately, the Ninth Circuit quickly reversed itself and determined that financial institutions can continue their long standing practice of simply crediting an account with social security direct deposits, even if the credit merely offsets an existing negative balance. Credit Unions on the west coast breathed a sigh of relief, and continued their existing practices regarding accounts receiving social security benefits.

## BANK OF AMERICA (CONT.)

**Billion Dollar Judgment**

In 2004, a California trial court held that while the practice may be permissible under federal law, it violated several California state laws. Damages awarded by the jury and the court against Bank of America in the case (*Miller v. Bank of America*) would likely reach $1.5 billion - yes, that's $1.5 billion. The judgment was based on claims for intentional and negligent misrepresentation, as well as violations of California's Consumer Legal Remedies Act, Unfair Competition Act, and False Advertising Act. The misrepresentation and false advertising claims were based on bank advertising and promotional materials indicating that direct deposits of social security funds were safe, sound, and immediately available. The plaintiffs also contended that the bank falsely represented that it could apply social security deposits to overdrafts and bank charges in the account. Other claims were based on the premise that California law prohibits financial institutions from applying exempt funds (including social security direct deposits) to any obligation owed to the financial institution, including negative balances in the account to which the deposits were made.

The trial court's ruling was based in large part on an older California case holding that the bank could not use exempt funds in a checking account to set off against a separate credit card account obligation owing to the bank. The trial court in *Miller* extended the older case to hold that a bank could not apply funds from exempt deposits to any obligation owing to the bank, even if that obligation is an overdraft in the account to which the funds are deposited. In other words, the court reached exactly the same ruling as in the original Lopez case, except the ruling was based on California law rather than federal law.

**Appeals Court Restores Sanity**

While this ruling was applicable only to California, financial institutions in other states have awaited the appeal eagerly, in hopes that similar cases do not sprout

*Cont. p 5*

## BANK OF AMERICA (CONT.)

up in other states. In a refreshing turn of events, the California Court of Appeals actually applied logic and sound reasoning, reversing the trial court. The Court of Appeals decided that an "account" involves both debits and credits, with the balance at any time being the result of both debits and credits. The court concluded that applying debits and charges arising through the normal operation of the account is not the same as exercising a right of offset against the account to cover unrelated debt. Applying debits and credits as they arise is a permissible (and necessary) exercise of the bank's accounting function. Because the bank's actions were permissible, all of the claims were dismissed, including the misrepresentation and false advertising claims. The plaintiffs have indicated that they will appeal to the California Supreme Court.

**Universal Principles**

The *Miller* case illustrates a number of principles that apply to all Credit Unions. First, it should be clear (at least here on the west coast) that exempt direct deposits can be applied to cover a negative balance in a checking account, even if that negative balance includes overdraft or NSF fees, or other account charges. Second, social security direct deposits or other exempt deposits should not be used to offset other obligations to the credit union, such as credit card debt or personal loans. Although an argument can be made that exercising the Credit Union lien or a right of offset is not the same as a garnishment, levy, or other judicial process, that argument will not be likely to prevail in the face of a challenge. Thus, if account funds consist solely of exempt deposits, you should think carefully before exercising the right of offset. Third, hungry plaintiff's attorneys will stretch logic to its limits in order to create liability for their targets. Avoid creating an opening for such attorneys. Fourth, jury trials can result in unexpected (and unsensible) verdicts. Fifth, most of the time, sanity and justice prevail in the end, but it is not always cheap to get there.

*Hal Scoggins*

## AUTOMATED VALUATION METHODS DO NOT SATISFY NCUA REAL ESTATE APPRAISAL RULES

Title insurance companies and other vendors are continually developing new products to make the real estate lending process more streamlined. One of these products is the "automated valuation method," which takes advantage of the ever increasing amount of online data regarding property tax assessments and sale transactions. Vendors offering AVMs use their database of property sales and tax assessment information, along with information regarding recent sales trends, to estimate market value for a particular property at a given point in time. Some vendors combine the AVM with an insurance policy as a package providing insurance coverage for Credit Unions to cover losses attributable to the difference between AVM estimate and the actual appraised value.

A recent NCUA General Counsel Opinion addressed the use of AVMs as a market valuation for real estate loans that do not require an appraisal. AVMs are clearly not appraisals, and will not satisfy the requirement of an appraisal in transactions exceeding $250,000. For transactions of $250,000 or less, however, the NCUA appraisal regulation does not require a full blown appraisal, but requires a "written estimate of market value." In the opinion (06-0824, October 31, 2006) http://www.ncua.gov/RegulationsOpinionsLaws/opinion_letters/2006/06-0824.pdf the NCUA General Counsel's Office indicated that AVMs may be useful in meeting a requirement for a written estimate of value, but do not by themselves satisfy that requirement.

NCUA Regulations Section 722.3(d) requires the written estimate of market value to be performed by an individual who is "qualified and experienced to perform such estimates of value for the type and amount of credit being considered." A credit officer or other Credit Union employee can satisfy this requirement, and may rely on the AVM in performing the estimate. But because an AVM does not include a qualified individual, it does not by itself satisfy the regulation. In other words, in the NCUA's eyes, property valuations still require the "human touch."

**In the NCUA's eyes, property valuations still require the "human touch."**

*Hal Scoggins*

## COMMERCIAL BOAT CONSTRUCTION LOANS COVERED BY MBL C&D RULES

If your Credit Union makes business loans for the construction of boats, you need to be aware of a recent opinion issued by the NCUA General Counsel Office. In Opinion Letter 06-1025 (November 6, 2006) http://www.ncua.gov/RegulationsOpinionsLaws/opinion letters/2006/06-1025.pdf, the NCUA General Counsel Office determined that a member business loan (MBL) for construction of a boat is subject to the special requirements for construction and development loans outlined in NCUA Regulations Section 723.3. Section 723.3 imposes three key requirements on construction and development (C&D) loans:

- The aggregate of all C&D loans is limited to 15% of the Credit Union's net worth;
- The borrower must have at least a 25% equity interest in the project being financed; and
- The Credit Union may disburse funds only in accordance with a pre-approved draw schedule, and only after performance of onsite inspections by qualified personnel.

All of the previous NCUA interpretations of the C&D requirements have dealt with real property. In this opinion, however, the NCUA took the position that a boat constitutes a "commercial property or structure." Application of the C&D rules to boat construction loans creates additional hurdles for such loans. Most importantly, the Credit Union must arrange for inspections by a qualified inspector or surveyor prior to each disbursement. The draw schedule must be sufficiently detailed to permit inspectors to make a determination as to whether the draw schedule milestones have been reached.

Oregon and Washington both have state member business loan regulations similar to the NCUA's. Oregon and Washington state chartered Credit Unions are subject to these regulations, rather than the NCUA's regulations. At this point it is unclear whether the Oregon Department of Consumer and Business Services or the Washington Department of Financial Institutions would interpret their regulations in the same manner as the NCUA.

Federal Credit Unions that have existing boat construction loans should be sure that these loans are classified as C&D loans for reporting purposes. For new boat construction loans, federal Credit Unions should comply with the equity and inspection requirements as well. Oregon and Washington state chartered Credit Unions may wish to check with their regulator before extending new boat construction loans to verify whether the state C&D requirements will apply.

*Hal Scoggins*

***CREDIT UNION ATTORNEYS:***

| | |
|---|---|
| *Brian Witt* | *bwitt@farleighwitt.com* |
| *Hal Scoggins* | *hscoggins@farleighwitt.com* |
| *Karen Saul* | *ksaul@farleighwitt.com* |
| *Dean Sandow* | *dsandow@farleighwitt.com* |
| *Valerie Tomasi* | *vtomasi@farleighwitt.com* |
| *Dave Ludwig* | *dludwig@farleighwitt.com* |
| *Michelle Bertolino* | *mbertolino@farleighwitt.com* |
| *Michelle Kerin* | *mkerin@farleighwitt.com* |
| *Kimberley McGair* | *kmcgair@farleighwitt.com* |
| *Bob Muraski* | *rmuraski@farleighwitt.com* |
| *Connie Speck* | *cspeck@farleighwitt.com* |
| *Chris Parnell* | *cparnell@farleighwitt.com* |
| *Cliff DeGroot* | *cdegroot@farleighwitt.com* |

**Portland Office:**
121 SW Morrison, Ste 600
Portland, OR 97204
Phone: 503.228.6044
Fax: 503.228.1741

**Central Oregon Office:**
750 Buckaroo Trail, Ste 203
Sisters, OR 97759
Phone: 541.549.4958
Fax: 541.549.4959

**www.farleighwitt.com**

**Who stands behind your Credit Union compliance?**