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CREDIT UNION EXECUTIVE NEWS

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MEMBERS' RIGHT TO KNOW—OR NOT

In the next several months, many credit unions will hold their annual member meetings. At this point, it is likely too late to provide much advice or guidance on nomination and election requirements as your election process is probably well under way. One area we may be able to assist credit unions is properly responding to members' demands or questions for more information. You do not want to be wrapping up an otherwise smooth annual meeting only to have the Board Chair blasted with member demands for the CEO salary or how much the Board spent sending the Board to Maui for "education". At all levels, the credit union needs to be prepared for these and other inquiries that members may expect to have the right to know.

Members' Right to Know

What information must the credit union provide to adequately inform members about the credit union operation and financial condition and what information is off limits? There is little legal guidance in this area and the response must be balanced and thoughtful. The Board cannot appear to be hiding embarrassing or sensitive information. At the same time, much of the credit union's information is proprietary or private for which no public disclosure is required.

The area of CEO salary is always particularly sensitive and the information subject to disclosure differs between

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PROTECTING YOUR CREDIT UNION'S GOOD NAME

Few credit unions still have the same name they did ten years ago. The reasons are many: new community charters and charter expansions, mergers, changes in sponsor companies, and outdated brand identity and the like. Regardless of the reason, credit unions are increasingly sensitive of the need for a clear identity in a fiercely competitive marketplace. In this ever changing world, credit unions need to be keenly aware of the need to secure and protect their good name.

We have assisted many credit union clients with a change of name and adoption of service marks to identify their financial services. The process is usually broken down into two phases: name selection and name implementation.

Name Selection

Focusing first on name selection, perhaps the most difficult part of the process is the selection of the name itself.

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Members' Right (cont.)

federal and state chartered credit unions. For FCUs, there is no required compensation disclosure as FCUs do not file Form 990s. State chartered credit unions must disclose this information on their Form 990s.

Even still, how can you be responsive, yet protective of the credit union staff? Here is one response you might consider: "The Credit Union Board is responsible for setting the Credit Union budget and CEO's compensation and benefits. We have set the level of our CEO's compensation to be competitive in the marketplace, based upon benchmark compensation amounts that CEOs of other similarly sized financial institutions receive. However, the specific amounts and terms of compensation of all of our Credit Union employees, including the CEO, is private and not a matter of public disclosure." Of course for state chartered credit unions, be prepared to reveal that general compensation is disclosed on the Form 990 and members may request a copy of that form. However, don't be baited into posting this on your credit union website.

Better Protection for the Credit Union—Member Rights Policy

I believe the credit union can better protect itself and be more responsive to members by taking one additional step. Develop, distribute and post a "Member's Rights" policy or statement. Under federal law and most state laws, members are afforded about a dozen distinct rights. It makes good sense to inform them of such rights including their specific rights to know and receive certain information about the credit union. Here is where you can clearly state what is available and what is not available or protected from broad distribution.

Your Board Chair is going to sound much more responsive to the membership being able to provide or refer members to a Member Rights policy which articulates in writing the information that is legally available, rather than stating the "Maui junket information" is off limits.

Let us know if we can assist you with a Member Rights policy or any other aspect of your annual meeting or corporate governance. Good planning is a good investment.

Brian Witt

Protecting Good Name (cont.)

We understand this process involves input from all sides: the Board, management, marketing, and outside consultants. Even if the credit union ultimately uses a dartboard, some preliminary legal issues need to be addressed.

Name Availability. The first task is to determine if the name is available. If another credit union or financial institution in the state has already used the name, the state and federal regulators will simply not approve the name change. Thus, the credit union should check with the NCUA or state regulator to assure that the proposed name is available from a regulatory standpoint. However, the name availability search does not end there. A much more critical risk is selecting and using a name that another financial service provider has used elsewhere in the country.

The credit union must avoid selecting a name that is so close to another existing name that it could create a potential for an infringement claim against the credit union. A name is not necessarily available if it is so close to existing uses as to create confusion, mistake, or deception among your members or the financial services marketplace at large. The only way to protect against other parties using the name or previously asserting a right to the name is searching trademark records at the state and federal level.

Some credit unions use marketing consultants to create, introduce and assist in narrowing the list of possible names. Sometimes, the credit union will just do a Google search themselves. While these are useful approaches for narrowing down the universe of potential names, these efforts alone do not provide adequate protection to permit the credit union to move forward with confidence that a legal objection will not lodged after the name rollout. If a name is introduced without a thorough screening search, you may end up expending significant resources to defend a decision when an alternate name could easily have been selected at the in the beginning. These costs can be avoided by obtaining a thorough trademark search and carefully considering early warning signs indicated by the search.

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In this ever changing world, credit unions need to be keenly aware of the need to secure and protect their good name.

PROTECTING YOUR CREDIT UNION'S GOOD NAME (CONT.)

Securing Your Name. Immediately after the new name is selected and even before the new name is rolled out to the membership, the credit union should take immediate steps to protect the name by obtaining federal and state service mark registrations. Credit unions often overlook the fact that their name is a service mark that identifies the source of all of the financial services offered.

In many cases, credit union names should be protected by registration. This issue should be reviewed by counsel well in advance of the effective date for the name change. Federal registration will protect against another party adopting the same or less than distinctive name and creating a risk of confusion with the credit union's name and brand. Federal registration provides a public record of prior right to the name, as well as the right to an injunction, damages, and attorney fees which are valuable tools to defend or challenge third party claims. State registration provides similar protection at the state level.

Most readers are familiar with the trademark term, such as the Nike swoosh use to identify Nike's products. A service mark is nearly identical to a trademark. The only significant difference is that a trademark applies to a tangible product whereas a service mark is used to identify intangible services. In the financial services world, your products are really services and thus we use the service mark term to identify the credit union as the source of the services. Beyond the credit union name, most credit unions will also have service marks in the form of logo designs (i.e. think Nike swoosh) as well as names given to your various products (*e.g.*¸ Super Jim Dandy Equity Line of Credit or Sav-U-Dough Visa Classic). While we focus here primarily on a change of name, the same analysis applies to the other service marks used by the credit union.

Name Implementation

As part of the name implementation phase, a number of different types of entities and persons should be given notice of the credit union name change when it becomes effective. Notice of the name change should be given to NCUSIF and the credit union's regulators, employees, software and forms vendors, webmaster, payroll processors, financial correspondents, legal counsel, accountants, insurers and sureties, retirement account sponsors and administrators, and general vendors. In addition, notice should be given to the US Postal Service, IRS and state tax authorities, and state employment divisions.

Of course, the members will be informed as part of the marketing rollout. Questions about the name change should be expected, and member service representatives should be instructed on the appropriate responses to the most anticipated member questions. If the credit union is changing away from a sponsoring employer's name, the credit union may want to take the politically expedient approach of informing the employer fairly early in the process. Finally, the marketing rollout will include advertisements in local newspapers, to others in the industry, and through the general media. This will help to get the word out on the name change.

Even without a name change, credit unions use many service marks in their daily operations. These marks identify the services, and ultimately they become your bread and butter. So, if you give a distinctive name to your financial products or services (*e.g.*, Super Bread and Butter Share Certificates or $$$s R Us) or you develop and use a distinctive logo, you should be considering your options for protecting these marks, too.

A change of name provides a fresh look for the credit union and interesting service marks identify exciting new financial products and services of the credit union. By making sure all appropriate steps are taken to screen and secure the name, trademark, or service mark, the credit union can best protect its good name. Farleigh Witt attorneys Dean Sandow and Bob Muraski are available to assist credit unions with every step of the process.

Dean Sandow

PREDATORY LENDING CASE ALTERS CONSUMER LAW LITIGATION LANDSCAPE IN OREGON

On January 26, 2007, the Oregon Court of Appeals handed down a case that is one of the best examples of the old adage "Bad facts make bad law." In *Vasquez-Lopez v. Beneficial Mortgage, Inc,* the plaintiff charged a mortgage lender with a number of predatory lending practices. The court considered four issues that frequently arise in consumer credit cases: (1) the enforceability of arbitration clauses (and whether enforceability should be determined by the court or an arbitrator); (2) the lender's ability to assert defenses based on a borrower's false statements in credit applications; (3) the acceptable ratio between punitive and compensatory damages; and (4) the circumstances which justify an enhanced award of attorneys' fees.

The court ruled against the lender on each of these issues, signaling an increasingly hostile judicial environment for creditors charged with consumer claims. While this case does not involve a credit union, credit unions should be aware of the litigation risks presented by this case.

Bad Facts Lead to Harsh Decision

The plaintiffs are immigrants who neither read nor speak English. They brought an action against Beneficial Mortgage, alleging that Beneficial engaged in predatory lending practices by (1) fraudulently inducing them to borrow money at an extremely high interest rate and (2) lying to them about what their monthly payments would cover. Beneficial sought to compel arbitration pursuant to an arbitration rider included among the loan documents.

The trial court determined that the arbitration rider was unconscionable, and therefore unenforceable. At trial, the jury found in favor of plaintiffs and awarded them compensatory damages of roughly $31,000 and punitive damages of $500,000. In addition, the court awarded "enhanced" attorney fees using an hourly rate above the rate normally charged by the plaintiff's attorneys. Each of these issues was appealed.

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arbitration rider's validity should have been submitted to the arbitrator for determination and not the court. The Court of Appeals held that the court is the proper forum to determine the validity of an arbitration clause if the "claim" addresses only the arbitration clause, or if the "claim" addresses the arbitration clause under a legal theory that is different from the theory related to the substantive claims under the contract. The court found that the plaintiffs' challenge to the arbitration provision (which was based on unconscionability) was distinct from their other claims against the lender (which were based on fraud). Accordingly,

The Court of Appeals also affirmed the trial court's finding that the arbitration provision was unconscionable, both in its substance the procedure used to obtain it. The court determined that the provision was procedurally unconscionable because it found that (1) the parties had unequal bargaining power and (2) Beneficial affirmatively concealed the terms of the arbitration rider. The court found that the arbitration provision was substantively unconscionable because it contained at least 3 terms that were unreasonably favorable to the defendant: a ban on class actions, a cost-sharing provision to equally divide any arbitration costs over $1,000, and a confidentiality provision.

Lender's Defense of Borrower Fraud Rejected

As a defense to the borrowers' claims, Beneficial asserted that the borrowers were precluded from recovering damages because their loan application failed to show a federal tax liability. The trial court directed a verdict for plaintiffs against this defense (in other words, the judge required the jury to rule this way). The Court of Appeals affirmed this ruling, holding that Beneficial's argument was fundamentally flawed and subject to many other shortcomings. The court held that defendant had no right to rely on plaintiffs' allegedly false returns because, as a large and sophisticated organization which employs under-writers whose jobs include reviewing loan applications for misrepresentation, it could discover this potential fraud internally before making the loan. According to the court, no reasonable juror could ever find that

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PREDATORY LENDING (CONT.)

Beneficial's reliance on the application was reasonable. This aspect of the court's opinion is the most troubling and has potentially significant impact on the viability of lender defenses based on fraudulent statements by borrowers in loan applications.

Punitive Damage Award Tied to Potential, Not Actual, Damages

A third major issue considered by the court of appeals was the jury's award of $500,000 in punitive damages. The trial court reduced the damages to $237,592.50, relying principally on the fact that the ratio between the punitive damages and compensatory damages awarded by the jury was approximately 15:1. The U.S. Supreme Court has generally held that punitive damages should not exceed compensatory damages by a ratio of more than 9:1. The trial court's award represented a ratio of 7.5:1. The Court of Appeals reinstated the jury verdict. The court determined that the case was one of "moderate reprehensibility," because no physical injury or threat to health or safety was involved.

However, the court decided that trial courts should not compare the ratio of punitive damages to actual damages, but instead should compare punitive damages to the amount of potential compensatory damages. In this case, the court found that potential compensatory damages equaled the amount of interest that would be payable over the life of the loan – more than $300,000. Thus, the original $500,000 punitive damage award was reinstated.

Enhanced Attorney Fees Award

The final issue considered by the court was whether plaintiffs were entitled to an "enhanced" attorney fee award. The plaintiffs' attorneys had been awarded $182,107.50 by the trial court. The court determined this amount by increasing the billing rates used to calculate the fees to provide a premium over the firm's standard fees. The trial court approved this premium based on evidence submitted by the plaintiffs that (1) established that few lawyers in Oregon were willing to represent clients in unfair or predatory mortgage lending cases because they are financially risky and involve complex issues; and (2) that the firm was required to work exclusively on this case during a one month period of time and forego other work.

Because of the significance of these issues, it is likely that the Oregon Supreme Court will hear an appeal of this decision some time later this year.

We will keep you posted.

Kathy Salyer

FEDERAL CIP COMPLIANCE REQUIRED FOR INDIRECT LENDING

Since May 2003, the USA Patriot Act has required credit unions to comply with the Customer Identification Procedures (CIP) for new members and borrowers. Credit unions must implement reasonable procedures to (1) verify the identity of any person seeking to open an account; (2) maintain records of the information used to verify the person's identity; and (3) determine whether the person appears on any government lists of known or suspected terrorists or terrorist organizations. Under the Treasury Department's CIP rule, it was never very clear whether the credit union needed to verify member identifications for indirect vehicle loans originated by the dealer as the originating creditor. Recent opinions from the Federal Reserve Board (FRB) staff clarify that the FRB believes that financial institutions must perform the customer identification procedure for those customers whose contracts are purchased from car dealers, or arrange with car dealers to perform the customer verification.

Verification in Indirect Loans

The confusion arises because in indirect lending, the dealer is actually the original creditor. The dealer enters into a retail installment contract with the buyer, then assigns the contract to the credit union. Typically, the vehicle dealer submits the credit application to the credit union for review. Often, dealers also submit the credit application to other

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CIP COMPLIANCE (CONT.)

financial sources for consideration. The applicant's consumer credit report is obtained by the credit union and the applicant's credit is evaluated. If the credit union deems the applicant creditworthy and if the dealer submits the retail installment contract to the credit union for purchase, the credit union will purchase the contract from the dealer. Dealers are not subject to the CIP rule, which applies financial institutions that open "accounts."

The CIP rule generally defines an "account" as a formal banking relationship established to provide or engage in financial services, or other financial transactions, such as a deposit account, a transaction or asset account, a credit account or other extension of credit. An account does not include an account that the credit union acquires through an acquisition, merger, purchase of assets or assumption of liabilities – the so called "transfer exception." Many financial institutions assumed that indirect auto loans fell within the "transfer exception" and have not bothered with the customer verification procedures for such loans. In the comprehensive Bank Secrecy Act and Anti-money Laundering Program we developed for credit unions, we stated: "although an indirect loan is technically originated by the dealer, the credit union should probably treat such loans as new accounts, subject to the rule." It appears our guidance to credit unions was consistent with the FRB's position in this matter.

Credit Union Compliance

While vehicle dealers do not, at this time, have a legal obligation to perform customer verification under the USA Patriot Act, the FRB expects that financial institutions will either perform the customer verification or contract with dealers to perform the customer verification. Thus, so long as the dealer has properly performed and documented the customer verification, the credit union need not do so. If the dealer and the credit union agree that the dealer will undertake the verification procedures, the dealer must obtain at a minimum, the following information from the customer: (1) name; (2) date of birth; (3) address; and (4) identification number (For U.S. citizens, this is a TIN. For non-citizens, it can be a TIN or unique identifying number issued by a foreign government.).

Most of this information is available from a driver's license, which dealers obtain in most cases. The identification number (social security number) would be included on the credit application and would be something that could be verified when looking at a credit report. Therefore, realistically, this information is already being gathered and what needs to be done by the credit union is to formalize it by requiring the dealer to provide it and by verifying that the procedures have been satisfactorily followed before funding.

Hal Scoggins

INTERESTING LAWSUIT OVER T.J. MAXX DATA SECURITY BREACH

On January 17, 2007, the retailer TJX Companies (parent of T.J. Maxx and Marshalls retail stores) announced a security breach to its computer network. The network handles customer transactions for over 2,500 retail stores and the breach resulted with the theft of millions of customers' personal credit, debit and driver license information. Within one week, the fraudulent use of the stolen information had been detected overseas. The compromised data was linked to card transactions made as far back as 2003.

TJX has come under fire for having learned about the breach in December and delaying its response until mid-January. In response, AmeriFirst Bank, an Alabama bank and TJX customer, filed a class action lawsuit against TJX and Fifth Third Bank of Ohio the card processor for TJX alleging: (1) common law claims of negligence, breach of contract, and negligence per se, and (2) failure to adhere to the financial institution's customer records privacy and data security safeguard's rule of the Gramm-Leach-Bliley Act (GLBA). It is expected that many other financial institutions will join the class action suit.

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SECURITY BREACH (CONT.)

To date, financial institutions have been frustrated in recovering damages, particularly direct fraud losses and card reissuance costs incurred from retail merchant security breaches. In 2006, the Pennsylvania State Employees Credit Union had brought suit against B.J.'s Wholesale Club to recover damages resulting from B.J.'s security breach. Unfortunately, the courts dismissed PSECU's claims for negligence and breach of contract. Also, VISA USA has virtually turned its back on noncompliance of the Payment Card Industry (PIC) Data Security Standards. Meanwhile, state and federal legislation has not been enacted as expected.

The AmeriFirst Bank case is particularly interesting as it involves a new, intriguing claim to data processor liability in its use of the federal data security requirements and standards under GLBA as the basis to assert a "negligence per se" claim. Under a traditional negligence per se claim, the plaintiff must show that the defendant's conduct constituted a violation of some statute or regulation and that the harm resulting from such conduct was the type of harm that the statute or regulation was designed to prevent. Unfortunately, the GLBA and its implementing regulations do not provide for a private right of action and many state data security statutes do not provide for a private right of action based on a failure to comply with such standards. However, the federal data security safeguard requirements contained in the federal banking regulations certainly present a widely accepted standard with which businesses that store consumer information must comply. In this case, the federal regulatory guidance serves as the basis for supporting common law tort claims against the third party processor and retail merchant.

Over the last 2 years, the FTC has settled more than a dozen compliance cases following data breaches, including ChoicePoint for $15 million. We are keeping a very close watch on this case and the novel claim asserted against the parties responsible for the data security breach.

Brian Witt

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