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Financial Services Insights | Summer 2020

Editors' Note:

Welcome to the inaugural issue of Greenberg Traurig's Financial Services Insights. The impact of Coronavirus Disease 2019 (COVID-19) has been both unexpected and devastating. As the economic fallout spreads, financial institutions are faced with major challenges in how they conduct business and interact with their customers. This newsletter reviews significant cases and legal developments affecting the financial services industry, including the CARES Act and related litigation, LIBOR developments, and regulatory enforcement actions.

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Spotlight on…

We are pleased to announce that two senior lawyers have joined GT's London office, strategically expanding its global disputes capabilities. Joining as shareholders are Masoud Zabeti, who served as the Head of the Finance & Banking Disputes Group at a Silver Circle UK firm, and Mohammed Khamisa, a senior Queen's Counsel in the Banking and Finance Group of the same firm. In financial services, Zabeti represents banks, private equity houses, hedge funds, asset managers, and inter-dealer brokers on a range of disputes, including those involving corporate and property acquisition finance. Khamisa has a diverse background from the English Bar and focuses his practice on commercial litigation, concentrating on complex multi-jurisdictional cases which often involve fraud, particularly within the banking and financial services sectors. They join GT with Ian Bean and Katharine Bond. Read the Press Release here.

Coronavirus Disease 2019-Related Alerts

Fair Credit Reporting Act (FCRA) Furnishers' Responsibilities Under the CARES Act

The recent passage and enactment of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) placed significant short-term obligations and restrictions on the rights of lenders and servicers of Federally-backed loans. As part of these limitations, which include moratoriums on foreclosures and mandatory forbearance obligations, the CARES Act placed short-term restrictions and requirements on the obligations of furnishers of information under the Fair Credit Reporting Act (FCRA). This GT Alert provides a brief outline of the FCRA reporting obligations created by the CARES Act, identifies some potential litigation concerns, and discusses certain considerations for minimizing risk of exposure. Continue reading the full GT Alert.

The CARES Act, Consumer Bankruptcy, and Mortgage Servicing: What to Know and Potential Pitfalls

Enacted March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) places short-term obligations and restrictions on lenders and servicers of federally backed loans. As part of these limitations due to Coronavirus Disease 2019 (COVID-19), lenders and servicers are temporarily subject to moratoriums on foreclosures, mandatory forbearance obligations, and revised credit reporting obligations. For borrowers currently in bankruptcy or who received a discharge but retained real property and continued making payments thereon, lenders and servicers should proceed with caution to minimize their risk of violating the Bankruptcy Code. This GT Alert outlines the obligations created by the CARES Act, identifies some potential litigation concerns, and discusses certain considerations for minimizing risk of exposure. Continue reading the full GT Alert.

Mortgage Foreclosure Moratorium – Potential Pitfalls and Mitigating Litigation Risks

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") became law. In addition to providing relief to various industries and businesses, the $2 trillion stimulus package placed several temporary moratoriums, prohibitions, and limitations of the rights of lenders and servicers of federally-backed loans. These include moratoriums on foreclosures and evictions, instituted mandatory forbearance obligations, and significantly relaxed loan modification requirements. These mandates may create a variety of litigation risks for distressed and delinquent loans. This Alert provides a brief outline of

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the obligations created by the CARES Act, identifies some potential litigation concerns, and discusses certain considerations for minimizing risk of exposure. Continue reading the full GT Alert.

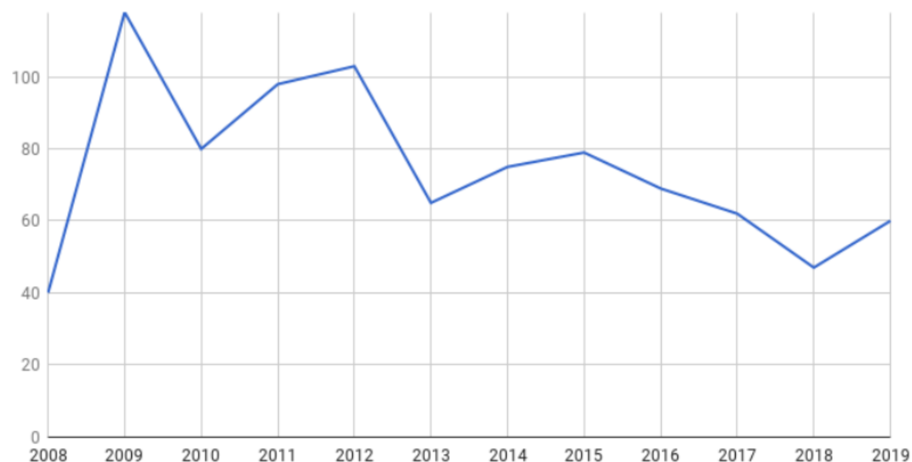
Massachusetts Land Court Dismisses Claim Asserting COVID-19-Related Impossibility Defense

In a June 1, 2020, decision and order, the Massachusetts Land Court dismissed the complaint of Christopher Martorella, who sought relief resulting from his failure to secure financing and inability to close a real estate transaction in the midst of the Coronavirus Disease 2019 (COVID-19) pandemic. Among other things, Martorella sought an injunction to continue the closing date of the subject real estate closing to July 6, 2020, on the basis that his performance was rendered impossible by the effects of the pandemic. Continue reading the full GT Alert.

Ponzi Scheme Discovery Boom May Follow in the Wake of Worldwide Economic Contraction: Case Law Update and Key Takeaways for Defending Aiding and Abetting Claims

By Jonathan Claydon

Looking back to the Great Recession of 2008 and 2009, the data reflect a sharp economic downturn has the result of forcing fraudulent schemes into the open. According to www.ponzitracker.com, more than double the number of Ponzi schemes were discovered in 2009 compared to 2008 before the recession began. The number of Ponzi schemes uncovered in 2010, while less than in 2009, was still double the number in 2008.



Source: Ponzitracker

This trend data indicate that the coming months could see a similar spike in Ponzi scheme discoveries. The spike may inevitably be accompanied by a corresponding uptick in actions by aggrieved investors or

receivers seeking to recover funds from financial institutions based on the theory that the fraudster's conduct was aided and abetted by the provision of banking, investment and transactional services.

In most jurisdictions, the three elements of an aiding and abetting claim are: (1) the existence of an underlying fraud or tort; (2) the defendant's knowledge of the underlying fraud or tort; and (3) the defendant's provision of substantial assistance to the scheme's commission. These cases often turn on application of prongs two and three. As the cases below illustrate, defendant banks often have success defeating these claims aggressively at the motion to dismiss stage where the allegations fail to sufficiently allege anything further than typical banking activity by the defendant. On the other hand, courts have denied motions to dismiss where plaintiffs have alleged specific facts indicating that the financial institution actually knew about the underlying fraud, particularly if the bank's conduct deviated from standard practice or directly benefitted the bank.

Isaiah v. JPMorgan Chase Bank, N.A., Case No. 17-15585 (11th Cir. June 1, 2020)

Factual Summary: The court-appointed receiver for several trading entities asserted claims against Chase for aiding and abetting a Ponzi scheme based on allegations that Chase helped facilitate the Ponzi scheme by transferring funds into, out of, and among the Receivership Entities' bank accounts, despite its alleged awareness of suspicious banking activity on those accounts. The trading companies had promised significant returns on investments supposedly involving the trade of Venezuelan and U.S. currency, but the investor "distributions" consisted merely of money invested by other duped investors instead of actual gains on legitimate investments. The receiver alleged that Chase had allowed the Ponzi entities to pass millions of dollars through their accounts before shutting down the accounts due to suspicious activity, only to allow the companies to open additional accounts. The receiver asserted that by allowing the Ponzi entities to open additional accounts after closing the initial accounts, Chase assisted the fraudsters by knowingly allowing them to "wind down" the fraud and transfer investor funds.

Legal Holding: The Eleventh Circuit confirmed the lower court's dismissal of the aiding and abetting claims against Chase on the grounds: (1) the complaint failed to sufficiently allege Chase had knowledge of the underlying fraud; and (2) the receiver lacked standing to bring the aiding and abetting claims because the fraudulent acts perpetrated by the Ponzi entities were imputed to the receiver.

Key Takeaway: The appellate court affirmed the trial court's dismissal of the aiding and abetting claims for the additional reason that a receiver standing in the shoes of the tarnished entities that benefitted from the fraud lacks standing to bring such third-party claims because it cannot be said to have suffered an injury from the scheme it perpetrated. The court differentiated these claims from claims brought by a receiver to recover fraudulent transfers, which the court held the receiver had standing to pursue.

Chang v. Wells Fargo Bank, N.A., Case No. 19-cv-01973 (N.D. Cal. April 7, 2020)

Factual Summary: Investors brought suit claiming that Wells Fargo aided and abetted a known Ponzi scheme wherein two fraudsters created a company that promised high returns for investments in pooled real estate funds. The fraudsters improperly commingled investment funds and siphoned large percentages out of the funds for personal use.

Legal Holding: The court denied Wells Fargo's motion to dismiss the aiding and abetting claims on the grounds plaintiffs sufficiently alleged Wells Fargo had direct and actual knowledge of the fraud based on its anti-money laundering (AML) and Bank Secrecy Act (BSA) monitoring obligations. Plaintiffs alleged that, as part of its AML and BSA duties, the bank reviewed the fraudulent company's accounts and

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learned that the fraudsters were commingling and misusing investor funds. The court held that plaintiffs' allegations of actual knowledge were plausible because they were supported by factual allegations that the bank: (1) reviewed the accounts as part of its "due diligence" obligations; (2) "manually processed" a huge amount of wire transactions that indicated on their face they were from investors; and (3) deviated from its procedures by accepting modified versions of deposit and transfer forms. The court also held that plaintiffs adequately alleged substantial assistance based on these supporting factual allegations.

Key Takeaway: Under California law, the court ruled even "ordinary business transactions" a bank performs for a customer can satisfy the substantial assistance element of an aiding and abetting claim if the bank actually knew those transactions were assisting the customer in committing a specific tort. Given that it was at the motion to dismiss stage, the Court held that it must take the plaintiff's allegations as true concerning the defendant's actual knowledge.

***Lucero v. IRA Servs.*, Case No. 18-cv-05395-LB (N.D. Cal. February 3, 2020)**

Factual Summary: Plaintiff invested his retirement savings in a self-directed IRA portfolio that promised large returns but turned out to be a Ponzi scheme. Plaintiff sued the fraudsters who ran the scheme, as well as the IRA services companies that acted as custodian and administrator of the account.

Legal Holding: The court granted a motion to dismiss filed by the financial institution defendants on the grounds plaintiff failed to sufficiently allege defendants had actual knowledge of the primary wrong they allegedly assisted. The court held defendants' knowledge that the investment advisor bought shares of stock at a lower value for his personal account than for plaintiff's account did not adequately plead that defendants knew that the advisors "were breaching their fiduciary duty to the plaintiff."

Key Takeaway: The court relied heavily on the California appellate court decision in *Casey vs. U.S. Bank Nat. Assn.*, 127 Cal. App. 4th 1138 (2005), which held plaintiff cannot satisfy the knowledge element of an aiding and abetting claim through an unspecific allegation that a financial institution is aware of wrongdoing generally.

***NCA Investors Liquidating Trust v. TD Bank, N.A (In re Seaboard Hotel Member Assocs., LLC)*, Case No. 15-12510, Adv. No. 17-51857 (D. Del. Bankr. Nov. 25, 2019)**

Factual Summary: In an adversary proceeding connected to the bankruptcy of the entity that managed individual pieces of real estate, the bankruptcy trustee alleged that TD Bank assisted in a fraud scheme whereby the management entity's executive: (1) knew that many of the real estate properties were not cash flow positive; (2) began commingling funds among the numerous investment parcels; and (3) subsidized disbursements from non-performing investments with revenue from performing investments. The trustee alleged that TD Bank aided and abetted the years-long fraud because it was aware the individual investments were supposed to be "siloed" but funds were regularly transferred between the accounts of the many debtor entities and most often into the account of a debtor who had an urgent use for funds.

Legal Holding: The court held the trustee had not sufficiently alleged TD Bank's knowledge of the fraud scheme because "the bank had no duty to monitor its customer's depositary accounts" and "[s]imply knowing that the investments were to be siloed is not enough to show reckless[] indifference." The court further held the trustee failed to allege substantial assistance because TD Bank's alleged conduct, i.e., allowing bank transactions and transfers, was "mere inaction" or "continued participation in a transaction," which is insufficient to show substantial assistance under Connecticut law.

Key Takeaway: Under Connecticut law, the standard required to show knowledge of the fraud is binary. Plaintiff must plead facts showing defendant had "actual knowledge of the underlying tort" or defendant acted with "reckless indifference to the possibility that the underlying tort is occurring." The court defined reckless indifference as "something more than a failure to exercise a reasonable degree of watchfulness to avoid danger to others or to take reasonable precautions to avoid injury to them."

Heinert v. Citizens Bank, et al., 410 F. Supp. 3d 544, Case No. 19-cv-6081 (W.D.N.Y. Oct. 18, 2019)

Factual Summary: 600 investor plaintiffs sued numerous banks asserting they had aided and abetted a fraudulent investment brokerage scheme in which numerous brokers funded their lavish lifestyle with investor funds. Plaintiffs further alleged a bank branch manager had a relationship with one of the brokers and assisted in the scheme by coordinating the opening of accounts, expediting the availability of funds, and lying to creditors.

Legal Holding: The court ruled plaintiffs failed to allege actual knowledge of the scheme because: (1) there were no facts alleged showing that the banks knew that their branch manager was involved; (2) a bank's merely negligent failure to identify red flags and warning signs of fraudulent activity are not sufficient to impute knowledge of fraud; (3) the allegations did not even show that the branch manager had actual knowledge of fraud as opposed to simply atypical business transactions; and (4) there were no facts alleged that the banks were aware of the offering materials reflecting the existence of a fiduciary duty. The court also ruled plaintiffs failed to allege that the banks substantially assisted the scheme because there was nothing more than the provision of "banking services."

Key Takeaway: The court relied heavily on the Second Circuit's statement "banks do not owe non-customers a duty to protect them from the intentional torts of their customers." *Lerner v. Fleet Bank, N.A.*, 459 F.3d 273, 286-87 (2d Cir. 2006).

Evans v. ZB, N.A., Case No. 18-15094 (9th Cir. June 24, 2019)

Factual Summary: Plaintiffs brought a class action complaint alleging that the bank's customer, "IMG," orchestrated a $100 million Ponzi-scheme in which it misrepresented to investors it had lucrative contracts to provide latex gloves to government agencies, but instead stole loan funds and used later investor monies to pay earlier investors. Plaintiffs further alleged the bank had knowledge the enterprise was a sham because it issued millions of dollars in loans to IMG and stopped loaning money after it learned that the company had little or no earnings from its claimed business.

Legal Holding: The Ninth Circuit reversed the district court's dismissal of the aiding and abetting claims on the grounds plaintiffs' allegations the bank knew the sham nature of the business were plausible since the bank: (1) required IMG to pay all funds into a "lock-box" account after IMG failed to make timely payments on a credit line; (2) maintained the lock-box account and monitored the deposits therein after it extended the maturity of the credit line; (3) had actual knowledge that IMG had no revenue from the sale of latex gloves; and (4) departed from standard industry practices by making advances without supporting documentation or proper verification. The court held the allegations plausibly alleged the bank knowingly assisted IMG to facilitate IMG's continued solicitation of cash investments because the bank knew those funds were needed to repay the bank loans in the absence of legitimate revenue.

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Key Takeaway: One judge filed a dissent arguing the dismissal should be affirmed because banks have no duty to supervise activity in customer accounts. But the majority rejected that notion stating "the question isn't whether [the bank] had a *duty* to supervise the account—the question is whether Plaintiffs allege that [the bank] actually did monitor the account."

Vasquez v. HSBC Bank, USA, N.A., Case No. 18 Civ. 1876 (S.D.N.Y. May 30, 2019)

Factual Summary: Plaintiffs asserted that HSBC assisted a Ponzi scheme in which investors were fraudulently induced to wire funds to HSBC USA accounts for investing in the cloud computing space. The investment turned out to be a classic pyramid scheme, and plaintiffs alleged HSBC learned of this fact in September 2013 but allowed the perpetrators to conduct transactions and transfer funds until March 2014. Plaintiffs claim that HSBC USA aided and abetted the Ponzi scheme because it had actual knowledge of fraudulent activity since it "flagged" one or more wire transfers sent in July 2013 and began an investigation into the Ponzi scheme entity.

Legal Holding: The court ruled that, in accepting the allegations as true as it was required to do that motion to dismiss stage, the plaintiff had adequately that HSBC USA "consciously avoided" knowledge of the fraud. The court defined conscious avoidance as "awareness of a probability of fraud and a decision to refrain from confirming that fact." The court ruled that Plaintiff's allegation that HSBC USA investigated a flagged wire meant that HSBC USA purportedly followed up its suspicions of fraud with an investigation that revealed the fraudulent nature of the customer's scheme. Nevertheless, the court dismissed the aiding and abetting claims because plaintiff failed to allege the element of substantial assistance. The court held that maintaining a correspondent account for the fraudster's Hong Kong accounts was merely inaction that did not rise to the level of substantial assistance, particularly where it was not adequately pled to be the proximate cause of the alleged fraud.

Key Takeaway: While the court found the allegations sufficiently to show "conscious avoidance" so as to satisfy the actual knowledge element of an aiding and abetting claim, the decision emphasized this standard was higher than a typical "constructive knowledge" standard. Conscious avoidance "involves a culpable state of mind whereas constructive knowledge imputes a state of mind on a theory of negligence."

Zhao v. JPMorgan Chase & Co., Case No. 17 CV 8570 (S.D.N.Y. March 13, 2019)

Factual Summary: Plaintiffs invested millions of dollars in a company that sold investments in restaurants and bars converted into work spaces for lease by professionals. The company raised more than $36 million, all of which was deposited into an account at Chase. The lone executive of the investment company absconded to Morocco with the funds and was later arrested. Plaintiffs allege Chase aided and abetted the fraudulent scheme by failing to properly vet the executive and his company when he opened the accounts at Chase and by knowingly providing banking services to a criminal enterprise.

Legal Holding: The court dismissed the claim for aiding and abetting a breach of fiduciary duty on the grounds that: (i1) plaintiffs failed to allege the existence of a fiduciary duty owed to plaintiffs by the investment company; (2) plaintiffs failed to allege any facts showing Chase had actual knowledge of a fiduciary relationship between plaintiffs and the investment company; (3) plaintiffs failed to allege that Chase had any knowledge of any breach or misconduct by the investment company. The court found, at most, Chase had access to the marketing materials given to the investors and had knowledge of banking transactions (frequent wire transfers, including to accounts in foreign countries), which the court found to fall short of alleging actual knowledge. The court also held the complaint failed to allege substantial assistance by Chase because: (1) inaction of an alleged aider and abettor constitutes substantial assistance

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only if the primary wrongdoer owes a fiduciary duty directly to plaintiff; and (2) the single affirmative action alleged—Chase declining a wire transfer recall request—was not an "atypical" or "non-routine" transaction.

Key Takeaway: The court cited approvingly an earlier Southern District of New York decision, *Nigerian Nat'l Petroleum Corp. v. Citibank, N.A.*, No. 98 Civ. 4960, 1999 WL 558141, at *7-8 (S.D.N.Y. July 30, 1999), which held there were insufficient allegations to establish a "strong inference of actual knowledge of fraud" where it was alleged the bank knowingly disregarded several indications of fraud, including fund transfers from a company account to a personal account.

In re Telexfree Securities Litigation, 357 F. Supp. 3d 122, MDL No. 4:14-md-02566 (D. Mass. Jan. 29, 2019)

Factual Summary: Plaintiffs alleged that numerous banks provided banking services to TelexFree, which was found to be running a pyramid scheme that negatively impacted over a million investors. Plaintiffs (in numerous consolidated actions) asserted that the banks ignored red flags and allowed TelexFree to make funds transfers to personal accounts of the founders, foreign entities and shell companies.

Legal Holding: The court granted defendants' motions to dismiss on the grounds that: (1) the provision of routine banking services was merely passive activity that was insufficient to establish substantial assistance; and (2) alleging that the banks had access to TelexFree's promotional materials, which should have alerted the banks that the TelexFree investment was fraudulent, was insufficient to plead actual knowledge.

Key Takeaway: The court was unequivocal, under Massachusetts law, "the fact that a bank *should have* recognized a fraud does not mean that it had *actual knowledge* of fraud."

Zayed v. Associated Bank, N.A., 913 F.3d 709, Case No. 17-1250 (8th Cir. Jan. 10, 2019)

Factual Summary: Scammers ran a lengthy Ponzi scheme that took in almost $200 million from investors who believed their funds were being invested in foreign currency indexes. A court-appointed receiver sued Associated Bank for aiding and abetting the scheme based on allegations a bank employee opened accounts for the fraudulent entities and serviced those accounts for the life of the scheme.

Legal Holding: The Eighth Circuit affirmed the grant of summary judgment for the bank on the grounds: (1) there was no direct evidence that the bank employee or anyone else at Associated Bank had either actual or constructive knowledge of the scheme; and (2) there was no evidence of substantial assistance by the bank, only the "provision of routine banking services."

Key Takeaway: Under Minnesota law, plaintiff can establish the knowledge element of aiding and abetting by showing the defendant had "constructive knowledge" of the fraud, but to do so it must show the "primary tortfeasor's conduct is clearly tortious or illegal."

Conclusion:

For financial institutions, the question now is not if you will be sued in connection with a Ponzi scheme; the question is when you will be sued and how often. As these authorities demonstrate, the key distinction between winning and losing an aiding and abetting claim is the depth and scope of the bank's knowledge of the conduct underlying the alleged fraud. Especially now, when customer activity may be altered by

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economic upheaval and customers may be seeking assistance in restructuring and/or reorganizing their debt obligations, it is important that customer-facing staff: (1) be aware of the risk of fraud; and (2) be reminded of the indicators of fraud and the importance of reporting and escalating any suspicious conduct/transactions.

Customer Misconduct and Litigation Risks: What to Know for Financial Institutions

By Michael Krauss

With this economic downturn, financial institutions can expect credit defaults, insolvencies, and misconduct by borrowers, depositors, and other customers. Cash-strapped borrowers may manipulate financial covenants, misstate borrowing base reports to avoid covenant violations, and misappropriate assets. Without new money coming in, existing frauds like Ponzi schemes will collapse and come to light. Banks and other financial services companies face the added risk of litigation by third parties who allegedly suffered losses due to the customer's misconduct. What are those risks and what steps may financial institutions consider mitigating them?

Civil Litigation Risks of Customer Misconduct

The potential civil claims against a bank arising from customer misconduct depend on multiple factors, such as the financial institution's role and relationship with the customer, and the specific facts of the customer's wrongdoing.

1. ***Aiding and abetting***. Among the most common claims are aiding and abetting fraud and/or breach of fiduciary duties by company insiders. Plaintiffs may include the trustee or receiver for the estate of the now-insolvent company. The law varies by state but aiding and abetting generally requires that the defendant had actual knowledge of the underlying fraud or breach and provided substantial assistance. A bank's negligent failure to identify warning signs of potentially fraudulent activity typically does not suffice. Nor does the provision of routine banking services in the midst of a continuing fraud.

   However, aiding and abetting claims have proceeded to discovery where the plaintiff alleged that the bank knowingly assumed a more active role in the customer's fraud. In one example, the plaintiffs alleged that the lender bank terminated its loans on discovering the borrower's Ponzi scheme—but then continued to provide other services that furthered the fraud and facilitated repayment on the loan. In another case, the plaintiff alleged that instead of just servicing a Ponzi schemer's deposit and checking accounts, the bank entered into account control agreements to help assure skittish investors.

2. ***Misrepresentation***. Also common are claims of misrepresentation, alleging that the financial services company made statements about the customer's finances and operations that are now known to be inaccurate. Buyers of interests in participation loans have sued the originators or lead lenders after the corporate borrower dissolved in fraud, alleging affirmative misstatements and the concealment of material facts despite a purported duty to disclose. Arrangers of syndicated credit facilities have faced similar suits. Defendants often have invoked the participants' and syndicate members' responsibility to conduct their own diligence and make independent credit determinations.

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Financial institutions also have faced claims for inaccurate asset values and descriptions in account statements—typically where the plaintiff alleged that the bank knew or recklessly disregarded the assets' true value or nature. Misrepresentation claims, whether negligent or intentional, are fact-intensive, and may also depend on the financial institution's exact role and obligations under contract.

3. ***Breach of contract.*** Where a corporate wrongdoer has established an account for the benefit of a third party—such as a trust account, escrow account, or control account—beneficiaries have sought to hold the bank liable for depleted assets by claiming breach of contract. The specifics depend on the contract terms and the individual facts. For example, plaintiffs have asserted that the bank disbursed assets at the wrongdoer's direction even though not all contractual requirements for release were met and there was no notice to other stakeholders. Also, plaintiffs have tried to identify language in which, they have claimed, the bank took on some responsibility for the value, form, or suitability of the assets.

Circumstances that have Accompanied Customer Misconduct

The circumstances accompanying customer misconduct may resemble a jigsaw puzzle—almost impossible to recognize before all the pieces are in place. Investors laud the hard-charging CEO who demands results, fast; but looking back, many high-profile frauds have featured such a domineering executive. Each situation is unique, and banks do not operate in hindsight. However, the following circumstances—particularly in combination—have accompanied customer frauds that gave rise to civil suits against financial services companies.

1. ***Management***. According to the Association of Certified Fraud Examiners (ACFE), fraud by a corporate owner or executive is the costliest and takes the longest to detect. Instances of fraud involving top management have included:

   - Companies where one person dominated the decision-making and insisted on control over external communications.

   - Efforts by management to intimidate lenders, auditors, and other financial service providers.

   - Refusals to allow due diligence, answer questions, and provide documentation.

   - High churn in banking relationships, auditing firms, and CFOs or accounting staff.

2. ***Transactional.*** Fraudulent financial transactions are varied and designed to avoid notice. Previous financial frauds have involved:

   - The rapid movement of funds with no apparent business purpose, such as round-trip transactions and successive refinancing.

   - A spike in transactions, particularly at quarter- or year-end.

   - Account activity at odds with the customer's stated expectations when opening the account—for instance, in terms of dollar amounts, transaction volume, and location or type of counterparties.

Steps to Consider

Typically, the sooner a corporate fraud is detected, the greater the opportunity to mitigate losses. According to the ACFE, tips are by far the most common method of initial detection. What can a financial institution do if an employee actively and actually suspects possible customer misconduct?

Concerns may be escalated to the institution's risk, compliance, and legal professionals. Among the primary considerations may be whether to file a suspicious activity report (SAR). The Bank Secrecy Act and its implementing regulations require a bank timely to report certain transactions that the bank "knows, suspects, or has reason to suspect" are suspicious. A transaction need not involve money laundering to trigger a SAR, and instead may involve fraud or other unlawful acts.

The specific steps in response to potential customer misconduct vary by the individual facts. But financial institutions should try to ensure that employees, both front-office and back, are aware of their roles, and the appropriate personnel are involved from the start. Banks may face difficult decisions about of a host of topics, such as:

- Further internal inquiry;
- Their relationship with the customer and any other counterparties;
- Asset preservation and recovery;
- Potential disclosures; and
- Government investigations or regulatory examinations.

Risk, compliance, and legal professionals may be best-equipped to help make reasoned, but timely, decisions in an effort to mitigate losses and liability.

Other Significant Industry Cases

United States v. NMAC, N.A., LLC, Case No. 3:19-cv-00658 (Middle District of Tennessee, Aug. 1, 2019)

By Joel Eads and Kathleen Kline

A claim by the Department of Justice (DOJ) for violations of the Servicemembers Civil Relief Act (SCRA) resulted in a $3 million settlement between the United States and NMAC, an automobile financing company, plus new safeguards going forward. The SCRA, 50 U.S.C. §§ 3901-4043, provides various protections to military servicemembers.

The DOJ alleged that NMAC had engaged in a pattern and practice of violating two sections of the SCRA, sections 3952 and 3955. First, section 3952 provides that while a borrower is in military service, a lender cannot repossess the borrower's vehicle without a court order, provided "a deposit or installment has been paid by the servicemember before the servicemember enters military service." Second, section 3955 provides that a lessee may terminate a lease for a motor vehicle without penalty if, after executing the lease, the lessee is called to military service for a period of 180 days or greater, or receives orders to

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relocate outside the continental United States (or from a location outside of the continental United States to any other state). A servicemember exercising this right is entitled to a refund of any advance payments on the lease.

The DOJ alleged that NMAC repossessed at least 113 vehicles in violation of section 3952 since 2008, and failed to provide refunds to an unspecified number of servicemembers who terminated vehicle leases pursuant to section 3955.

In addition to the $3 million payment, meant to compensate victims identified by the DOJ, NMAC agreed to enact policies and procedures to ensure compliance with the SRCA going forward. These include requiring that NMAC search the Defense Manpower Data Center (DMDC), a database reflecting servicemembers' military status, both before ordering a repossession and throughout the repossession process. If the DMDC indicates that a borrower is a protected servicemember, NMAC shall seek a court order before repossessing the vehicle. NMAC also agreed to develop and train employees on policies ensuring that servicemembers protected under section 3955 will receive the refunds to which they are entitled. NMAC further agreed to request that credit bureaus remove from borrowers' accounts trade lines reflecting wrongful repossessions, and from lessees' accounts trade lines reflecting lease termination. Going forward, NMAC must notify the United States every six months of any complaint it has received claiming a violation of the SCRA.

DiNaples v. MRS BPO, LLC, 934 F.3d 275 (3d Cir. 2019)

By Joel Eads and Kathleen Kline

The Third Circuit upheld judgment for plaintiff in a class action alleging that a QR code printed on an envelope violated the Fair Debt Collection Practices Act (FDCPA). Defendant MRS BPO (MRS), a debt collector, sent plaintiff, a debtor, an envelope marked with a QR code, which, when scanned with a smartphone revealed MRS's internal reference number for plaintiff's account.

The FDCPA prohibits debt collectors from:

> [u]sing any language or symbol, other than the debt collector's address, on any envelope when communicating with a consumer by use of the mails or by telegram, except that a debt collector may use his business name if such name does not indicate that he is in the debt collection business.

15 U.S.C. § 1692f(8). Courts do not always apply this provision literally, since that "would seemingly prohibit including a debtor's address and an envelope's pre-printed postage, as well as any innocuous mark related to the post, such as 'overnight mail' and 'forwarding and address correction requested.'" *DiNaples*, 934 F.3d 275 at 281 (citations omitted). However, the Third Circuit previously held that a debt collector violated the FDCPA when it sent an envelope printed with the debtor's internal account number, finding that this type of "disclosure implicates a core concern animating the FDCPA – the invasion of privacy." *Douglass v. Convergent Outsourcing*, 765 F.3d 299, 303 (3d Cir. 2014).

The Western District of Pennsylvania determined, and the Third Circuit agreed, that there was "no meaningful difference between displaying the account number itself and displaying a QR code – scannable by any teenager with a smartphone app – with the number embedded." *DiNaples*, 934 F.3d at 278. Both displays implicate the same privacy concerns.

As a threshold question, the Third Circuit considered whether plaintiff had standing to sue – whether she suffered a concrete injury through MRS's mailing a collection letter in an envelope printed with a QR code that, when scanned, could reveal her status as a debtor. Relying on prior holdings where a printed account number satisfied the injury-in-fact requirement, the court found that plaintiff did have standing. "Disclosure of the debtor's account number through a QR code, which anyone could easily scan and read, still implicates core privacy concerns." *DiNaples*, 934 F.3d at 280. The court rejected defendant's argument that plaintiff must show that her mail was intercepted and the code was scanned and interpreted. Instead, the court held that the disclosure of an account number is in itself the harm the FDCPA seeks to prevent, and a plaintiff need not show any injury beyond disclosure. *Id*.

Litigation Risks: Secured Overnight Financing Rate

By Lisa Simonetti

The London Inter-Bank Offered Rate (LIBOR) has been widely used as the index for adjustable rate, residential mortgage loans (ARMs). By some estimates, approximately $1 trillion in ARMs in the United States are tied to LIBOR. This consists of some 2.8 million loans and over half of the currently outstanding ARMs. ARMs typically may feature an initial, fixed rate for a specified number of years, based on an index plus a margin, and then annual or monthly rate changes, with a rate cap (and sometimes a floor).

As explained in our LIBOR Transition Newsletters, the Alternative Reference Rates Committee (ARRC) has recommended a new rate, the Secured Overnight Financing Rate (SOFR), to replace LIBOR. In ARRC's view, SOFR should be a reliable alternative, and not susceptible to manipulation.[1] Unlike LIBOR, SOFR is based on an active and well-defined market, and uses observable transactions, rather than estimates. Notwithstanding these benefits, the plaintiffs' bar will be looking for opportunities, particularly on a class basis, to argue that the use of SOFR disadvantages mortgage loan borrowers [by injecting uncertainty and increasing their interest payments].[2] Plaintiffs may pursue various theories of liability, and noteholders and servicers may wish to act now to minimize the risk of litigation.

Contract-Based Claims

In contract, plaintiffs may focus on the specific language in the underlying mortgage agreements. For example, on Fannie Mae/Freddie Mac mortgage loans, the uniform note provides the right to substitute a new index, if the agreed index is "no longer available," based on "comparable information." But there is no guidance as to how these phrases should be construed or applied, leaving them open to interpretation by the courts with potentially divergent results. Meanwhile, some mortgage agreements are silent as to the unavailability of the original rate and/or use of a substitute rate.

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[1] There are several variations of the SOFR. For purposes of mortgage servicing, the substitute rate likely will be SOFR Compounded in Advance – e.g., for a 30-day SOFR beginning April 1, SOFR would be compounded from March 1-30 to determine the rate.

[2] Michael Held, executive vice president and general counsel of the Federal Reserve Bank of New York, characterized the LIBOR transition as a "DEFCON 1 litigation event," a "situation that invites litigation . . . on a massive scale." Speech, "SOFR and the Transition from LIBOR" (Feb. 26, 2019).

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Depending on the specific language, plaintiffs might assert claims for: (1) anticipatory breach or repudiation before LIBOR is extinguished; (2) breach of the note, asserting that the rate term is or became ambiguous, and the note should be interpreted against the drafter to include the most favorable rate; (3) frustration of purpose or impossibility of performance, arguing that the noteholder/servicer was required to negotiate a new rate, and seeking to discharge the duty to pay; or (4) specific performance, arguing for the use of LIBOR as it existed at a particular point in time.

Noteholders and servicers may consider various defenses, which generally protect parties against unforeseen circumstances at the time of contracting, when neither party contemplated the end of LIBOR. These include: (1) acts of government/change in law; (2) mutual or unilateral mistake (assuming that LIBOR would remain in place for the life of the loan); and (3) the necessity and fairness of reformation (the parties agreed to a variable rate tied to a third party/unbiased, longstanding, industry-accepted benchmark and, therefore, SOFR is appropriate).

Along with contract theories, plaintiffs might also assert claims for unjust enrichment, promissory estoppel, or breach of the covenant of good faith and fair dealing. Plaintiffs would argue, in essence, the "inequity" of the rate substitution.[3]

Statutory Claims

Plaintiffs may take advantage of the liability standards and multiple remedies under the various states' unfair and deceptive acts and practices statutes (UDAPS). For instance, California's Unfair Competition Law, Cal. Bus. & Prof. Code § 17200, *et seq.* (UCL), prohibits any "unlawful, unfair or fraudulent business act or practice." The law is "intentionally framed in broad, sweeping language." It heavily favors consumers (*see Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co.*, 20 Cal. 4th 163, 181 (1999) and entitles plaintiffs to restitution and injunctive relief.[4] The same is true of other states' UDAPS, which generally permit the recovery of damages (sometimes trebled/punitive) and injunctive relief, and often attorneys' fees (e.g., Mass. Gen. Laws ch. 93A § 4, N.Y. Gen. Bus. Law § 349).

Practical Considerations

The central premise of any litigation may be that the use of SOFR may cause harm to borrowers. Accordingly, in implementing SOFR, noteholders and servicers could consider a conservative approach, particularly in regard to the applicable margins and rate caps. Having said that, a conservative approach may create tension with investors, who could object to lower returns. These competing interests may be considered and balanced, and some of ARRC's recommendations for new ARMs may assist, including:

- Using either a 30- or 90-day SOFR average to set rates, which will mitigate the risks of single-day fluctuations. The Federal Reserve Bank of New York is set to begin publishing SOFR averages in the first half of 2020.

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[3] Plaintiffs also may attempt negligence claims, although courts generally hold that lenders/servicers do not owe a legal duty. Moreover, plaintiffs could assert fraud-based claims, but these are often difficult to pursue in a proposed class-action given individualized issues of reliance, causation, and harm.

[4] There are regulatory risks related to the LIBOR transition. For example, state and local authorities can bring enforcement actions under the UCL, which carry the potential for civil penalties up to $2,500 on a per-violation basis. Further, there is the potential for enforcement at the federal level, including from the Consumer Financial Protection Bureau.

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- Setting the rate by reference to an average of SOFR, calculated over a given span of time.
- Restructuring rate caps to contain a one percent periodic adjustment to offset potential monthly payment increases to borrowers.

Servicers may wish to provide clear disclosures to borrowers about the LIBOR transition, and what it will mean for them. These disclosures may consider the content of the underlying notes, and all applicable banking, securities and consumer protection laws. Servicers may add LIBOR issues to their complaint tracking systems, monitor complaints for repeated topics, and address borrower concerns on a reasonable basis.

Finally, noteholders and servicers can continue to look for guidance from ARRC and state and federal regulators.

HUD Fair Housing Act Proposed Rule

By Cindy Hamilton and Shauna E. Imanaka

Artificial intelligence is changing the way banks interact with their customers, anti-fraud support, and credit underwriting. However, the use of algorithms has generated some concern over machine learning bias that may perpetuate the disenfranchisement of vulnerable populations grounded in traditional banking models. The United States Supreme Court long ago confirmed that even unintentionally discriminatory business practices may violate federal law if they cause disproportionate harm to minorities, known as "disparate impact." *See Griggs v. Duke Power Company, 401 U.S. 424 (1971).* Large banks face continued scrutiny for policies that may inadvertently have a disparate impact on communities of color. However, new regulations that address inadvertent discrimination under the Fair Housing Act (FHA) may lay the groundwork for a potential "safe harbor" where financial institutions responsibly use algorithms in an effort to reduce risk.

In *Texas Department of Housing & Community Affairs v. Inclusive Communities Project* (135 S. Ct. 2507 (2015), the Supreme Court extended disparate impact liability to policies and practices that disproportionately harm people protected by the FHA. The Court affirmed the application of the disparate impact liability to claims under the FHA after the nonprofit demonstrated that a tax credit program resulted in Texans being segregated by race. The Court's recognition of disparate impact liability under the FHA is a warning that discrimination, even through an algorithm that inadvertently injures a protected class, can lead to expensive litigation.

However, in response to *Inclusive Communities Project*, in August 2019, the U.S. Department of Housing and Urban Development (HUD) proposed a rule that would make it harder to claim disparate impact discrimination under the FHA. *See* HUD's Implementation of the Fair Housing Act's Disparate Impact Standard, 84 Fed. Reg., 42854 (Aug. 19, 2019) (to be codified at 24 C.F.R. 100). The proposed rule may be finalized in 2020. In addition to imposing a new five-pronged standard to prove disparate impact liability, the proposed rule provides new defenses — particularly where the challenged policy or practice relies on an algorithmic model. HUD explained that there is a need to provide a "safe harbor" for "algorithmic models to assess factors such as risk or creditworthiness." HUD continued: "While disparate impact provides an important tool to root out factors that may cause these models can also be an invaluable tool in extending access to credit and other services to otherwise underserved communities." The three proposed defenses under the proposed rule are:

1. The specific inputs used in the algorithmic model are not substitutes for a protected characteristic and the model is predictive of risk or other valid objective. Breaking down the model piece-by-piece, each input could not be the cause of the disparate impact and instead advances a valid objective.

2. A recognized third party created and maintained the model. The model is standard in the industry, it is being used for the intended purpose of the third party, and is the responsibility of the third party.

3. A neutral qualified expert has analyzed the model and determined it was empirically derived, its inputs are not substitutes for a protected characteristic, the model is predictive risk or other valid objective, and is a demonstrably and statistically sound algorithm.

The proposed rule has the potential to change the landscape of disparate impact claim litigation and help safeguard the responsible use of artificial intelligence by credit providers. Banks may consider vetting new algorithmic models, or revisions to existing models, against these proposed defenses.

Managing the Impact of Regulatory Enforcement Actions on Potential Civil Liability

By Michael Krauss

Enhanced regulatory scrutiny is now a hallmark of the financial services industry. The 2010s saw approximately 2,500 enforcement actions by the Office of the Comptroller of the Currency (OCC), which is the primary regulator of national banks and federal savings associations. Prominent examples include actions to enforce compliance with the Bank Secrecy Act (BSA), which governs anti-money laundering (AML) programs, and compliance with laws governing mortgage loan servicing, modifications, and foreclosures. The OCC brought dozens of enforcement actions in the first quarter of 2020 alone.

Well after it is finished, a regulatory enforcement action may have a longstanding impact on a bank's potential civil liability to customers, shareholders, and others. The action is a matter of public record: final orders and assessments of penalties are available online, often accompanied by press releases and media reports. Plaintiffs have invoked OCC consent orders as proof of everything from unfair trade practices to poor internal controls. To help manage civil litigation risk, here are three questions a bank may consider when agreeing to resolve an OCC enforcement action.

1. ***Does agreeing to a consent order prevent discovery of the underlying facts in civil litigation?*** If a plaintiff complains of the same conduct and time period that was the focus of the regulatory action, the court may permit at least some discovery regarding the consent order. For example, discovery has gone forward where plaintiff alleged that the bank's conduct, be it related to loan servicing or customer due diligence, was widespread and systemic, and the consent order supposedly helped establish the bank's knowledge and state of mind with respect to plaintiff.

   If, however, the bank can distinguish a plaintiff's claims from the subject matter of the consent order, then the court may strictly limit such discovery or bar it altogether. Discovery must be proportional to the needs of the case, and courts seek to avoid "mini-trials on separate unrelated lawsuits." In one 2019 case, plaintiff borrower charged a bank with unfair practices in plaintiff's home foreclosure sale, and plaintiff sought discovery into an OCC consent order that addressed the bank's foreclosure processing. Plaintiff requested information regarding the bank's actions and knowledge related to the

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order, the process leading up to the order, and its actions following the order. The court denied all such discovery as irrelevant, overly broad, and unduly burdensome. It observed that the foreclosure in the case took place two years before the consent order; the specific actions of which plaintiff complained—sale scheduling and notice—were not mentioned in the order; and the order did not contain any admission of liability.

2. ***Could the bank be forced to disclose its communications with regulators?*** Discovery into the consent order typically may not extend to the bank's communications with regulators — and that includes ongoing communications about how the bank implements and complies with the order. The order is public, but related communications remain "non-public OCC information," which belongs to the OCC and a bank may not unilaterally disclose. To obtain this information, plaintiff must follow the OCC's administrative process, which places a high bar on disclosure. *See generally* 12 C.F.R. §§ 4.31-4.40. Common examples of "non-public OCC information" include the bank's responses to regulators' questions, plans and recommendations provided to regulators, and internal documents prepared as a direct result of or in connection with the examination process.

3. ***Could the OCC consent order be used against the bank at trial?*** Even if the enforcement action arguably informs the plaintiff's claims, a bank has various grounds to argue that the consent order may not be used at trial. Foremost among them is the rule that a settlement agreement is not admissible to "prove or disprove the validity or amount of a disputed claim." Fed. R. Evid. 408. The rule promotes the public policy favoring settlement and recognizes that settlement "may be motivated by a desire for peace rather than from any concession of weakness of position." *Id.* advisory committee's note.

Critically, the typical OCC consent order is labeled a "settlement," and the bank "neither admits nor denies" the OCC's findings. Courts nationwide have held that Rule 408 bars the admission of consent orders and consent decrees with government agencies like the OCC. Most recently, in another 2019 case, plaintiff sought to use an OCC consent order addressing a bank's BSA/AML compliance as evidence that the bank willfully failed to monitor the transactions and accounts in its case. The court applied Rule 408 to exclude from trial the consent order and related government investigations evidence, observing that plaintiff improperly sought "to introduce these documents to validate its claims."

However, the same analysis does not necessarily apply to assessments of penalties by the Financial Crimes Enforcement Network (FinCEN), which also enforces BSA/AML compliance. Unlike the OCC, FinCEN requires banks to accept responsibility for BSA/AML violations and admit the underlying facts. Accordingly, a court may be less likely to exclude a consensual FinCEN assessment from trial. A bank should be prepared for its acceptance of responsibility and admissions of fact to be used as evidence of liability in civil litigation and be careful to craft a defense that does not contradict the FinCEN's assessment of penalty.

The facts of each case will differ, but keeping these questions in mind when resolving a regulatory enforcement action may help manage potential civil liability down the road.

This Greenberg Traurig Newsletter was prepared by the firm's Financial Services Litigation Group.

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