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In 2001, the Consumer Finance Report was awarded "best newsletter" by the Legal Marketing Association, Bay Area Chapter. It is edited by Joseph W. Guzzetta, with the assistance of Evelina Manukyan and Elizabeth Holt Andrews, and is published three times each year for the benefit of our clients and others with concerns requiring current information focusing on California developments in the areas of consumer finance and litigation. Joseph Guzzetta is an associate of the Firm who specializes in defending financial institution clients against single-plaintiff lawsuits and class action cases. He can be reached in the San Francisco office or by email at jwg@severson.com. The contents of this publication are for informational purposes only. No responsibility is assumed for errors in the publishing process.

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CONSUMER FINANCE REPORT

CALIFORNIA DEVELOPMENTS FROM A BUSINESS PERSPECTIVE

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Fraudulent Wire Transfers And The Commercially Reasonable Standard Under UCC Article 4A

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According to a May 2017 Public Service Announcement by the Federal Bureau of Investigation ("FBI"), cyber-initiated wire fraud is not just on the rise—it is exploding. Data collected by the Internet Crime Complaint Center ("IC3") reflects a 2,370% increase in reported fraud loses between January 2015 and December 2016. Between October 2013 and December 2016 there were 22,292 reported cases of fraud by domestic victims. The aggregate loss was $1.6 billion. Victims of this type of fraud include individuals and businesses of all sizes and across all industries. IC3 data includes fraud that is occurring in all 50 states and 131 countries. Suffice it to say, cyber-initiate wire fraud is a real and immediate threat to financial institutions and their customers.

Although the perpetrators of cyber-initiated wire fraud employ an arsenal of tools that are constantly evolving,

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The California Supreme Court Continues Its Resistance To Arbitration

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"Resistance" is now the battle cry of the self-anointed defenders of consumer rights. But this is nothing new for the California Supreme Court, which for over 20 years has resisted the mandate in the Federal Arbitration Act ("FAA") to enforce arbitration agreements despite their collateral effect on class actions. Beginning with *Southland Corp. v. Keating*, 465 U.S. 1 (1984), and reaching its high watermark in *Discover Bank v. Superior Court*, 36 Cal. 4th 148 (2005), the California court repeatedly struck down traditional arbitration agreements so that class actions could proceed. The sea change came with the United States Supreme Court's decision in *AT&T Mobility v. Concepcion*, 563 U.S. 333 (2011), which expressly condemned the *Discover Bank* decision. Since then, the California Court has grudgingly acceded to the federal mandate. *See, e.g.*, *Sanchez v. Valencia Holdings Co. LLC*, 61 Cal. 4th 899 (2015).

But not so fast. In its most recent encounter with the FAA, the California Supreme Court believes that it has found a clever way to carve out a major exception to *Concepcion*. In *McGill v. Citibank, N.A.*, 2 Cal. 5th 945 (2017), the court held that claims for injunctive relief that benefit the public in general do not require class certification and are, therefore, safe from the reach of *Concepcion*. In order to reach this result, the court twisted the meaning of its own state law enacted by the public through the initiative process and reduced *Concepcion* to a mere procedural ruling with implications only for the procedural aspect of class actions. It remains to be seen whether this latest affront to the Supremacy Clause will find its way to the United States Supreme Court, but, if it does, the High Court appears to be growing impatient with state efforts to evade the FAA, as Kentucky learned recently in *Kindred Nursing Centers Ltd. Part. v. Clark*, 137 S. Ct. 1421 (2017).

Undermining Proposition 64. To understand how the California court rationalized the result in *McGill*, we must take a detour back to the election of November 2, 2004 and Proposition 64, which was enacted under the state initiative procedure. Prior to Prop. 64, California's Unfair Competition Law (Bus. & Prof. Code §§ 17200 *et seq.*) ("UCL"), allowed any unaffected person to bring an injunctive action on behalf of the general public without the necessity of class certification. And to ensure that such claims could proceed in court, the California Supreme Court had issued two rulings that rejected any attempt to arbitrate such claims for injunctive relief under the UCL or its companion statute, the Consumer Legal Remedies Act ("CLRA"). *Cruz v. PacifiCare Health Systems, Inc.*, 30 Cal. 4th 303 (2003) (UCL); *Broughton v. Cigna Healthplans*, 21 Cal. 4th 1066 (1999) (CLRA). The potential for abuse from such an unrestrained process was obvious.

Prop. 64 was designed to end this abuse, and was passed in a lopsided 60-40% vote by the same general public the UCL was supposedly protecting. Prop. 64 reined in the UCL by adding a standing and class certification requirement that mirrored federal law. A claimant seeking relief on behalf of the general public now had to show a personal loss of money or

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property ***and*** seek class certification under California's class action statute (Cal. Code Civ. P. § 382). As a setup for its anti-arbitration holding, the *McGill* court simply ignored the plain language of Prop. 64 and held that the pre-existing right to seek injunctive relief on behalf of the general public somehow escaped the requirement for class certification for any "representative action." While not explicitly reaffirming *Cruz* and *Broughton*, this legal sleight of hand effectively meant that, according to California law, an individual could seek injunctive relief on behalf of the public only in court.

Undermining the FAA. But what about the FAA, *Concepcion* and the Supremacy Clause of the United States Constitution, you ask? That takes us to the second part of the *McGill* decision. According to the California Supreme Court, the right to seek a public injunction is not merely a procedural alternative to a class action—it actually creates a substantive right, the waiver of which is contrary to California policy. And any contract, including an arbitration agreement, that purports to waive such a right is unenforceable. The California court then used this "procedure v. substance" argument to brush aside *Concepcion*, which it narrowed to a holding dealing only with the tension between arbitration and class actions:

> … contrary to Citibank's assertion, *Concepcion* and its high court progeny actually *support* the "draw[ing]" of a distinction between class claims and public injunctions. The latter is a *substantive statutory remedy* that the Legislature, though the UCL, the CLRA, and the false advertising law, has made available to those, like McGill, who meet the statutory standing requirements for filing a private action. A class action, by contrast, "is a *procedural* device that enforces *substantive* law by aggregating many individual claims into a single claim … It does not change that substantive law." (*In re Tobacco II Cases*, *supra*, 46 Cal.4th at p. 313, italics added …)

Through this judicial rewriting of Prop. 64 and tortured interpretation of *Concepcion*, the California court has effectively allowed class type claims to once again trump legally binding arbitration clauses. Since *McGill*, the class action bar has begun filing single plaintiff lawsuits seeking public injunctions based on alleged violations of consumer protection statutes, including injunctions against collection of debt by financial institutions.

The Kentucky Supreme Court attempted a similar end-run around the FAA and *Concepcion* by interpreting its power of attorney statute to require a power to expressly empower the attorney to enter into an arbitration agreement on behalf of a nursing home patient. According to the Kentucky court, this was an enforceable substantive requirement of its statute. In a 7-1 ruling (with Justice Thomas dissenting on other grounds), Justice Kagan wrote the opinion of the Court and disagreed, showing some obvious frustration with the states' continuing attempt to undermine *Concepcion*. *Kindred Nursing Centers Ltd. Part. v. Clark,* 137 S. Ct. 1421. Let us hope that *McGill* gets similar treatment by the High Court.

For more information on the McGill decision and public injunctive relief, please contact Donald J. Querio at djq@severson.com or 415-677-5621, or Erik Kemp at ek@severson.com or 415-677-5556.

BANK OPERATIONS

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the schemes generally fall into one of two categories. One type of fraud involves the use of phishing, social engineering, malware and/or hacking to gain access to the victim's online bank account in order to directly initiate an unauthorized wire transfer with the victim's financial institution. A second type of fraud involves the use of email, sent to the victim by the fraudster from a spoofed or hacked account, containing wire instructions with erroneous account information. For the purposes of this article, wire transfers resulting from the first category of fraud will be referred to as "unauthorized". Transfers resulting from the second will be referred to as "authorized".

With the dramatic rise in cyber-initiated wire fraud, financial institutions will inevitably be confronted with pre-litigation demands and lawsuits from customers relating to authorized and unauthorized transfers. The focus of this article is on providing an overview of the legal framework applicable to claims brought against financial institutions by customers relating to unauthorized wire transfers. Further, this article will examine some of the tools financial institutions have made available to combat cyber-initiated wire fraud and how those tools fit within the legal framework.

The Legal Framework: Uniform Commercial Code Article 4A. Article 4A (also known as Division 11) of the Uniform Commercial Code ("UCC") sets forth a carefully chosen set of rules that allocate the risk of loss among the participants in "funds transfers" involving "payment orders" (e.g. wire transfers). The Official Comments to Article 4A reflect that the rules governing wire transfers were written on a "clean slate" using "precise and detailed rules" in order to balance the "competing interests[] of the banks that provide funds transfer services and the commercial and financial organizations that use the services." Cal. U. Com. Code § 11102, Official Cmt. The rules described under Article 4A are "intended to be the exclusive means of determining the rights, duties and liabilities of the affected parties." *Id.*

Under the framework of Article 4A, a "receiving bank" (the bank that receives wire instructions from a sender) ordinarily bears the risk of loss of any unauthorized transfer. However, risk of loss is shifted to the customer under two independent circumstances.

First, under UCC Section 11202(a), the customer will bear the loss when the "payment order received ... is the authorized order of the person identified as sender if that person authorized the order or is otherwise bound by it under the law of agency." Stated differently, if the financial institution received wire instructions from an authorized agent of its customer, then the customer will bear any resulting loss from any wire transfer. The liability analysis under UCC Section 11202(a) is straightforward: if the individual who

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PRIVACY AND DATA BREACH

Banks Face Unique Liability For Data Breaches Under The Gramm-Leach-Bliley Act

Author:
Bernard J. Korberg

With the recent alleged data breach of Equifax, the data security of financial institutions' customer information is once again in the news. And once again, as with every data breach, a flurry of lawsuits has followed. The purpose of this article is to highlight one area of legal exposure with data breaches that applies only to financial institutions.

Section 6285 of the Gramm-Leach-Bliley Act ("GLBA") provides that the various agencies charged with the regulation of financial institutions "shall prescribe such revisions to such regulations and guidelines as may be necessary to ensure that such financial institutions have policies, procedures, and controls in place to prevent the unauthorized disclosure of customer financial information." 15 U.S.C. § 6821. The enforcement authority of this section is granted to the Federal Trade Commission ("FTC") for non-banking financial institutions, and the regular host of agencies for banks and credit unions. 15 U.S.C. § 6822.

The FTC requires institutions it regulates to "develop, implement, and maintain a comprehensive information security program," the goal of which is to "(1) Insure the security and confidentiality of customer information; (2) Protect against any anticipated threats or hazards to the security or integrity of such information; and (3) Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer." *See* 16 C.F.R. § 314.3.

In order to effect these steps, covered institutions are required to (1) designate an employee to coordinate the implementation of the security program; (2) perform risk assessment in the areas of employee training, information technology, and detecting and responding to attacks; (3) design and implement safeguards to protect against these identified risks; (4) oversee and monitor vendors to ensure they also take steps to protect customer information, and include contractor requirements that they do so; and (5) continue to test these programs to identify risks as they emerge. *See* 16 C.F.R. § 314.3.

Similarly, for banking institutions, the Federal Reserve, Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision have issued their Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice. This guidance implements, in greater detail, the same priorities as the FTC program. In addition, this guidance requires that a covered bank have a response program in place in the event of a data breach that includes notifying appropriate regulators, taking steps to control the breach, and notifying consumers of the breach. 12 C.F.R. § Pt. 225, App. F.

These rules, which were implemented in the early 2000's, have never had greater effect than today. While beforehand, government agencies were generally content to only prosecute the perpetrators of data breaches, that is no longer the case. Regulators now have put emphasis on investigating and penalizing the victims of data breaches with multi-million dollar fines for "allowing" data breaches to happen due to allegedly insufficient data security policies. The FTC, for example, has a webpage for the sole purpose of trumpeting the fines it has imposed on companies where private customer information has been stolen. *See* https://www.ftc.gov/news-events/media-resources/protecting-consumer-privacy/enforcing-privacy-promises.

Similarly, plaintiff's lawyers have also taken note of these regulations. The prevalent view is that "[n]o private right of action exists for an alleged violation of the GLBA." *Dunmire v. Morgan Stanley DW, Inc.*, 475 F.3d 956, 960 (8th Cir. 2007); 15 U.S.C. § 6822. Accordingly, the class action bar have recently sought to tie alleged failures to comply with data breach regulations to violations of state laws regulating "unfair or deceptive" acts by businesses. Similarly, plaintiffs also have alleged that a breach of these regulations constitutes negligence *per se*. While no reported case has yet upheld these allegations as viable claims, the claims themselves, coupled with the alleged breach of a detailed scheme by the government, has no doubt raised the cost of settlement of these lawsuits.

Unfortunately, the risk of theft of private customer information is only going to increase as time goes on. Accordingly, now is the time for any lender, big or small, to review its policies and procedures regarding information security to ensure it is complying with the Gramm-Leach-Bliley Act. A failure to do so may compound the damage caused by the data breach with the cost of defending a costly investigation or lawsuit.

For more information regarding the Gramm-Leach-Bliley Act's data security rules, please contact Bernard J. Kornberg at bjk@severson.com or 415-677-5548.

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protection could include permitting the tenant to remain in the premises. *Spanish Peaks*, 862 F.3d at 1156. Unfortunately, in this case the tenants did not raise the issue of adequate protection until the appeal.

Takeaway. With this decision, the Ninth Circuit has formally joined the minority when it comes to the question of whether property in bankruptcy may be sold free and clear of leaseholds. Had the tenants properly raised the issue of adequate protection under Section 363(e) at the bankruptcy court level, they likely would have received something on account of their interest, including possibly remaining in possession (leases, unlike lien interests, are more difficult to satisfy by proceeds from the sale). Bankruptcy sales can move very quickly and, no doubt, debtors/trustees will take full advantage of the *Spanish Peaks* decision. Tenants must be vigilant and timely assert appropriate arguments to protect valuable leasehold interests.

For more information regarding the Spanish Peaks decision specifically, or bankruptcy law generally, please contact Donald H. Cram, III at dhc@severson.com or 415-677-5536.

EMPLOYMENT UPDATE

Mortgage Loan Underwriters Are Non-Exempt Employees–The “Administrative Employee” Exemption Does Not Apply

Author:
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On July 5, 2017, the Ninth Circuit Court of Appeals dealt a blow to Provident Savings Bank, FSB (“Provident”) in a class action suit brought against Provident by mortgage underwriters who sued for overtime compensation under the Fair Labor Standards Act (“FLSA”), 29 U.S.C. § 201, *et seq.* The Ninth Circuit agreed with plaintiffs that they had been misclassified by Provident as exempt employees, reversed the decision of the United States District Court for the Eastern District of California granting summary judgment in the bank’s favor, and remanded the case with instructions to enter summary judgment in plaintiffs’ favor.

Plaintiffs in *McKeen-Chaplin v. Provident Savings Bank, FSB*, 862 F.3d 847 (9th Cir. 2017) were mortgage underwriters employed by Provident, to review and approve of mortgage loan applications. As those in the financial services industry know, it is the underwriter who verifies the information contained in mortgage loan applications, compares that information to the applicable guidelines for each loan product, and determines whether or not the applicants meet those guidelines. The underwriters do not, however, control how the loans are funded or what types of loans should be offered.

Non-exempt employees are entitled to overtime pay, but exempt employees are not. Provident classified its mortgage underwriters as exempt employees under the administrative employee exemption of the FLSA. An employee can be classified as exempt under the administrative exemption if: (1) the employee is compensated not less than $455 per week; (2) the employee’s primary duties involve office or non-manual work related to the management or general business operations of the employer or employer’s customers; and (3) the employee’s primary duties involve the “exercise of discretion and independent judgment with respect to matters of significance.” 29 C.F.R. § 541.200(a).

The *Provident* court split from the Sixth Circuit, which had held that mortgage underwriters do fall within the administrative exemption (*Luz v. Huntington Bancshares, Inc.*, 815 F.3d 988, 995 (6th Cir. 2017)), and adopted the position held by the Second Circuit did in *Davis v. J.P. Morgan Chase & Co.*, 587 F.3d 529 (2d Cir. 2009). The *Davis* court held that mortgage underwriters are non-exempt employees because the work they perform is more functional rather than conceptual, and the underwriters have no role in determining the future strategy or direction of the business. Agreeing with the *Davis* court, the Ninth Circuit acknowledged that while the mortgage underwriters could not be cast as assembly line workers, their duties were more related to the production side of the enterprise rather than the internal administration side. And as the *McKeen-Chaplin* court noted, administrative exemptions are construed narrowly against the employer. In essence, the Ninth Circuit took the position that the primary duties of mortgage underwriters did not involve the “exercise of discretion and independent judgment with respect to matters of significance.”

This case is yet another cautionary tale about the importance of correctly classifying employees. A misclassification can result in employers being liable for up to four years of back pay for overtime hours that the misclassified employees did not receive in compensation. The employer will also be liable for the misclassified employee’s missed meal and rest breaks, as well as for wage statement violations.

For more information regarding correctly classifying your employees, please contact Diane P. Craig at dpc@severson.com or 415-677-5530, or Rhonda L. Nelson at rln@severson.com or 415-677-5502.

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provided the wire instructions to the financial institution was authorized to do so—either expressly or under agency law—then the financial institution’s customer will bear any loss that occurs from the transfer.

Second, the customer may bear the loss of any fraudulent wire transfer if under UCC Section 11202(b) the financial institution and its customer have agreed to security procedures designed to protect against the risk of fraud. Analysis under Section 11202(b) involves two-steps. First, the financial institution must prove that the agreed upon security procedures are “a commercially reasonable method of providing security against unauthorized payment orders.” Whether a particular security procedure is commercially reasonable “is a question of law to be determined by considering” the customer’s stated expectations, the customer’s known needs, alternative security procedures offers, and security procedures used by similarly situated banks and customers. Cal. U. Com. Code § 11202(c). Second, the financial institution must “prove[] that it accepted the payment order in good faith and in compliance with the security procedure and any written agreement or instruction of the customer restricting acceptance of payment orders issued in the name of the customer.” Cal. U. Com. Code § 11202(b).

In performing the two-step analysis under UCC Section 11202, it is important to keep in mind that “security procedure” is a term of art specifically defined by Article 4A as “a procedure established by agreement of a customer and a receiving bank for the purpose of … verifying that a payment order or communication amending or cancelling a payment order is that of the customer.” Cal. U. Com. Code § 11201. So security procedures must be agreed to by the financial institution and the customer. And their purpose, put most simply, is to make sure that the person providing the wire instructions is the bank’s customer and not an imposter.

It should go without saying that the use of a log-in ID and password alone will not be deemed commercially reasonable in most cases. There are a number of additional security procedures that financial institutions have made available to their customers for the purpose of preventing unauthorized transfers. And while not dispositive of the “commercially reasonable” inquiry, the availability of the following procedures weigh heavily in favor of the financial institution.

Tokens. A token is a physical device that is used to authenticate the person initiating a transaction. A common example of a token is a key fob that generates a unique numeric authentication code at fixed intervals of time. The use of tokens satisfies one prong of a “multi-factor” authentication process—“[t]he process of using two or more factors to achieve authentication. Factors include something you know (e.g., password or personal identification number); something you have (e.g., cryptographic identification device or token); and something you are (e.g., biometric).” *See* https://ithandbook.ffiec.gov/it-booklets/information-security/appendix-b-glossary.aspx.

Tokens (or the lack thereof) played an important role in *Patco Const. Co., Inc. v. People’s United Bank*, 684 F.3d 197 (1st Cir. 2012). In *Patco*, the court of appeals reversed a summary judgment order in favor of the defendant-bank, finding that the bank’s security procedures were not commercially reasonable. In particular, the court faulted the bank’s failure to offer a hardware-based token to its customer. Although the opinion does not describe in detail the evidence presented by the parties on this issue, the court concluded that by 2009 most “internet banking security had largely moved to hardware-based tokens and other means of generating ‘one-time’ passwords.” *Patco*, 684 F.3d at 212. Therefore, because tokens were “in general use by … receiving banks similarly situated,” the defendant-bank’s security procedures fell below what was commercially reasonable. *See* Cal. U. Com. Code § 11202(c).

Although the use of tokens (or at least the offering of tokens to customers) may not be sufficient to determine that a financial institution’s security procedures are commercially reasonable, tokens are an important factor for the fact finder to consider.

Dual Control. “Dual control” is a security procedure whereby one person initiates a wire and another person is required to approve it. Like tokens, the availability of “dual control” weighs heavily in favor of a finding that a financial institution’s security procedures are commercially reasonable. In *Choice Escrow and Land Title, LLC v. BancorpSouth Bank*, 754 F.3d 611 (8th Cir. 2014), the court of appeal agreed with the trial court that “dual control” is a commercially reasonable security procedure. *Id.* at 622. The court succinctly described the advantage of a “dual control” security feature: “[w]ith dual control in place, a customer’s account remains secure even if a third party manages to obtain an employee’s password and IP address; to issue a payment order, that third party would have to obtain a second, wholly independent set of identifying information.” *Choice Escrow*, 754 F.3d at 620. Of course, it is not enough to simply recommend that customers establish internal levels of authority for requesting and approving wire transfers. As the trial court in *Texas Brand Bank v. Luna & Luna, LLP*, 2016 WL 3660579 (N.D. Tex. Jan. 29, 2016) explained, “a recommendation [that the customer establish two levels of authority to request and transmit monetary transfers] does not automatically yield an offer.” *Id.* at *3.

In the *Choice Escrow* case, the bank did not simply recommend that the customer create two levels of control—it offered a specific “dual control” security feature. Although the customer declined to implement the bank’s “dual control” procedure, that did not result in an adverse finding against the financial institution. Rather, the court’s 11202 analysis focused on the fact that the bank offered the “dual control” procedure to its customer, that the customer was advised that “dual control” provided a safeguard against fraud, and that the customer thereby assumed the risk of declining the security procedure.

As with tokens, the availability of a “dual control” security feature may not be sufficient to conclude that a financial institution’s security procedures are commercially reasonable. But making such a procedure available to customers—even if customers decline this additional layer of security—will certainly weigh in favor of the institution in the eyes of the fact finder.

Internal Security Procedures, Fraud Monitoring, and Risk Scoring. While tokens and “dual control” are relevant to the “commercially reasonable” analysis of a financial institution’s security procedures under Section 11202(c), there is a good argument to be made that the bank’s internal risk scoring processes should be excluded from that analysis. As discussed above,

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"security procedure" has a very specific definition—it must be "established by agreement of a customer and [the] bank." Proprietary processes that are not expressly incorporated into the agreement with a customer do not fit within Article 4A's precise definition. This interpretation of the limited scope of the definition of "security procedure" is supported by the Official Comments to UCC Section 11201. "The term does not apply to procedures that the receiving bank may follow unilaterally in processing payment orders." Cal. U. Com. Code § 11201, Official Cmt. This argument was accepted by the court of appeal in *Skyline Intern. Development v. Citibank*, 302 Ill. App. 3d 79. The court held that "the violation of this internal procedure was not a violation of a security procedure since the bank and its customer had not agreed that the authorization of wire transfers would be verified pursuant to Citibank's security procedures." 302 Ill. App. 3d at 84-85.

In *Experi-Metal, Inc. v. Comerica Bank*, 2011 WL 2433383 (E.D. Mich. June 13, 2011), a phishing scheme resulted in more than 90 fraudulent wires. At trial, the defrauded bank customer argued that the defendant bank "failed to meet industry or commercial standards" because it did not employ "fraud scoring and fraud screening." 2011 WL 2433383, at *12. The trial court rejected this argument, finding that the plaintiff failed to prove that "a bank had to provide fraud monitoring with respect to its commercial customers to comport with 'reasonable commercial standards of fair dealing.'" *Id.* The court's conclusion, however, was based on deficiencies in the testimony of plaintiff's expert witness rather than any interpretation of the definition of "security procedure" under Section 11201.

Lastly, the *Choice Escrow* court rejected the customer's argument that a commercially reasonable security procedure requires "transactional analysis" of "the size, type, and frequency" of wire transfers processed by the bank. *Choice Escrow*, 754 F.3d at 619. However, the scope of the court's holding may be somewhat limited by the fact that the "transactional analysis" the customer was advocating for was a manual review by a human being—something the court rejected as being impractical.

Conclusion. Cyber-initiated wire fraud presents a growing, undeniable threat. Financial institutions will face claims from customers over unauthorized wires initiated by third-parties. To be prepared to defend against these inevitable claims, it is essential for financial institutions to understand the legal framework on which those claims will be analyzed. The Uniform Commercial Code requires that security procedures be "commercially reasonable." What is commercially reasonable is not determined by a fixed checklist, but rather by reference to "banks similarly situated." Cases like *Patco* and *Choice Escrow* help to provide guidance on what security features have been deemed commercially reasonable.

For more information regarding wire fraud and the legal framework relating to such claims, please contact Mark I. Wraight at miw@severson.com or 415-677-5630.

MORTGAGE UPDATE

Ninth Circuit Upholds Preemption Of Nevada Super-Priority Statute

Author:
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In what should end a long simmering legal brushfire, the Ninth Circuit held that the Federal Housing Finance Agency's ("FHFA") so-called "Federal Foreclosure Bar" preempts Nevada's homeowners association lien super-priority statute, thereby protecting Fannie/Freddie mortgage liens from being extinguished through foreclosure of later-recorded homeowners association liens. *Berezovsky v. Moniz, et al.*, 869 F.3d 923 (9th Cir. 2017).

Berezovsky purchased a home at a homeowners association foreclosure sale. He filed suit in state court asserting that the Nevada super-priority statute allowed the homeowners association to sell the home free and clear of other liens, irrespective of priority. Freddie Mac intervened, removed the case to federal court, and, joined by the FHFA, moved for summary judgment, arguing that the Federal Foreclosure Bar in the Housing and Economic Recovery Act of 2008 ("HERA"), 12 U.S.C. §§ 4511, 4617(J)(3), preempts Nevada's super-priority statute. The United States District Court for the District of Nevada granted summary judgment, holding that pursuant to this statutory conservatorship provision, FHFA-owned first priority liens were protected from non-consensual foreclosure.

On appeal, in a question of first impression, the Ninth Circuit found that the FHFA conservatorship lien protection powers applied to private foreclosures generally, distinguishing the Fifth Circuit's decision in *F.D.I.C. v. McFarland*, 243 F.3d 876 (5th Cir. 2001), which held that a similar statute protecting Federal Deposit Insurance Corporation receiverships was limited to tax sales. The court also rejected arguments that Freddie Mac implicitly consented to the foreclosure sale by taking no action to stop it, and that Freddie Mac had no property interest to protect because it "split" the ownership of the promissory note (held in its name) and beneficial interest under the deed of trust (held in the name of Mortgage Electronic Registration Systems, Inc. ("MERS"), and then the servicer).

This decision should unequivocally protect Fannie/Freddie first mortgages from any further claims based on Nevada's super-priority statute.

For more information regarding homeowners association super-priority statutes, please contact Michael J. Steiner at mjs@severson.com or 415-677-5611.

BANKRUPTCY UPDATE

Ninth Circuit Determines That A "Free And Clear" Sale Of Real Property Under Section 363(f) Extinguishes A Leasehold Interest

Author:
Donald H. Cram, III

The Ninth Circuit recently determined, in *Pinnacle Rest. at Big Sky, LLC v. CH SP Acquisitions, LLC (In re Spanish Peaks Holdings II, LLC)*, 862 F.3d 1148 (9th Cir. 2017), that a sale of real property free and clear of liens and interests under Section 363(f) of the United States Bankruptcy Code, 11 U.S.C. § 363(f) ("Section 363(f)"), can terminate a leasehold in the underlying property notwithstanding the provisions of Section 365(h) favoring non-debtor lessees. In so holding, the Ninth Circuit joins the minority of courts allowing such property to be sold in bankruptcy free and clear of these leasehold rights.

At issue in *Spanish Peaks* is the interplay between Sections 363 and 365 of the Bankruptcy Code. When a lessor/debtor or trustee in a bankruptcy case rejects a real estate lease, the lessee is afforded certain statutory protections under Section 365(h) of the Bankruptcy Code. In such instances, the non-debtor lessee can treat the lease as terminated and assert a damages claim. Alternatively, the lessee can waive any claim against the bankruptcy estate, retain possession of the leasehold property for the remaining lease term, and continue to pay rent (offset by any actual costs incurred based on non-performance by the debtor/lessor).

Section 363 of the Bankruptcy Code gives a debtor or trustee the ability to sell property of the bankruptcy estate free and clear of liens and interests if certain requirements are met. Under the usual scenario, liens held by secured creditors are stripped off and attached to the sale proceeds in order of priority.

Under the Ninth Circuit's ruling in *Spanish Peaks*, a tenant of a bankrupt landlord could find itself with no interest in the property following the sale.

Facts and History. The debtor was one of the multiple entities involved with Timothy Blixseth and the resort he and others had planned in Big Sky, Montana. The resort project was funded by a $130 million loan secured by a mortgage on the resort property and an assignment of rent. After the loan, the debtor entered into two leases at the resort with two related entities. One, a restaurant lease for a term of 99 years for $1,000 per year in rent. And a second lease for a parcel of property with a term of 60 years at an annual rent amount of $1,285.

The debtor defaulted on its loan payments for the resort and filed for relief under Chapter 7 of the United States Bankruptcy Code. The Chapter 7 trustee and the lender agreed that the trustee would sell the resort property "free and clear of any and all liens, claims, encumbrances and interest" pursuant to Section 363(f). The bankruptcy court, after some procedural hurdles, entered an order approving the sale of the resort property to the lender for $26.1 million under Section 363(f). At the conclusion of the sale to the lender, the two lessees argued that, under 11 U.S.C. § 365(h), the lender took the property subject to the two long-term leases.

After a two-day hearing on the matter, the bankruptcy court authorized the sale free and clear, on the grounds that the trustee had met the applicable requirements under Section 363(f). The bankruptcy court noted that the tenants failed to requested adequate protection of their leasehold interests under 11 U.S.C. § 363(e). The district court affirmed.

On appeal to the Ninth Circuit, the tenants asserted that Section 365(h) should govern their leasehold rights in the real estate, as opposed to Section 363(f). The tenants also argued that there was no basis under Section 363(f) to sell the real property free and clear of liens. The trustee maintained that Section 365(h) did not apply because the trustee was seeking to sell the real property, rather than to reject the lease. Furthermore, the trustee argued that Section 363(f)(1) authorized a free and clear sale. Section 363(f)(1) allows such a sale if "applicable non-bankruptcy law permits sale of such property free and clear of such interest." The trustee pointed out that under Montana state law, if the bank had foreclosed on the real estate, the leases would have been extinguished.

Ninth Circuit Reasoning. The Ninth Circuit acknowledged that, when Sections 363 and 365 collide, the majority of courts have held that Section 365 trumps Section 363 under the canon of statutory construction that the specific prevails over the general. The specific protections afforded to lessees under Section 365(h) would be rendered meaningless if the real property could be sold free and clear of the leasehold under the more general provisions of Section 363(f).

The Ninth Circuit also acknowledged that the only court to reach a different conclusion was the Seventh Circuit in *Precision Industries, Inc. v. Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp. & Qualitech Steel Holdings Corp.)*, 327 F.3d 537 (7th Cir. 2003). In *Qualitech Steel*, the Seventh Circuit concluded that there was no conflict between Sections 363 and 365 because Section 363(f) confers a right to sell property free and clear of "any interest," without excepting from that authority leases entitled to the protections of Section 365(h). By contrast, Section 365(h) has a more limited scope – defining the rights of a lessee affected by the rejection of a lease by the debtor or trustee. The Seventh Circuit also noted that in the contract of a free and clear sale, the lessee is not left without a remedy. The lessee has the right to seek protection under Section 363(e), and upon request, the bankruptcy court must ensure that the lessee's interests are adequately protected.

The *Spanish Peaks* court adopted the "minority" approach as set forth in *Qualitech Steel*. The court noted that no party was seeking to reject the lease, and therefore Section 365 did not apply. The court also agreed that foreclosure law could be relied upon to meet the Section 363(f)(1) free and clear sale requirement. In addition, the court pointed out that Section 363(e) provides a "powerful check on potential abuses of free-and-clear sales" and that, depending on the circumstances, adequate

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