ReedSmith
The business of relationships.℠

Virginia Financial Institutions Newsletter

June 2013

CFPB AMENDS ABILITY-TO-REPAY RULE TO EASE STANDARDS FOR SMALL CREDITORS

Joseph ("Jay") E. Spruill, III
Counsel– Richmond, VA
Financial Industry Group
jspruill@reedsmith.com

On May 28, the Consumer Financial Protection Bureau (the "CFPB") finalized important amendments to its ability-to-repay rule. Among other things, the amendments are intended to help small creditors comply with the law and preserve consumer access to credit from such creditors. "Small creditor" is defined in the rule to generally mean a creditor with no more than $2 billion in assets that (along with affiliates) originates no more than 500 first-lien mortgages covered under the ability-to-repay rule per year.

Under the original ability-to-repay rule issued in January of this year, the CFPB authorized certain balloon-payment mortgages to be designated as qualified mortgages if originated and held in portfolio by "small creditors" operating predominantly in rural or underserved areas. The CFPB's amendments to the January rule make changes to further benefit small creditors as follows:

New Small Creditor Qualified Mortgage

The final rule adopts a fourth category of qualified mortgages for loans originated and held in portfolio for at least three years by small creditors (subject to certain limited exceptions). This provision applies to small creditors even if they do not operate predominantly in rural or underserved areas. These loans are not subject to the debt-to-income ratio limit (i.e., no greater than 43 percent) under the general qualified mortgage definition. However, such loans must meet the general restrictions on qualified mortgages with respect to loan features and points and fees, and small creditors will still need to evaluate a consumer's debt-to-income ratio or residual income.

Safe Harbor Protection for More Small Creditor Mortgage Loans

The final rule raises the "safe harbor" threshold for certain qualified mortgages made by small creditors. For balloon loans and portfolio loans that are qualified mortgages,

the threshold separating those loans that receive a safe harbor as opposed to those that merely receive a rebuttable presumption of compliance is raised from 1.5 percent above the average prime offer rate (the "APOR") to 3.5 percent above the APOR.

Transition Period for Balloon Loans

The final rule provides for a two-year transition period during which balloon loans made by small creditors may meet the qualified mortgage requirements. In particular, for two years from the effective date of the final rule, small creditors that do not operate predominantly in rural or underserved areas can offer balloon-payment qualified mortgage loans if they hold them in portfolio. During this two-year period, the CFPB intends to study whether the definitions of "rural" or "underserved" should be adjusted and to work with small creditors to transition to other products, such as adjustable-rate mortgages, that satisfy other qualified mortgage definitions.

While these changes represent progress for community banks and credit unions, there are legitimate concerns that they do not go far enough. Of particular note, many community banks and credit unions have more than $2 billion in assets, or make more than 500 first-lien covered mortgages per year, or both, and will thus not get any benefit from these changes. Industry representatives will undoubtedly seek further easing of the ability-to-repay requirements to help smaller institutions.

The final rule is effective January 10, 2014.

ASSISTANT MANAGERS FAIL TO BREAK THE PIGGY BANK...FOR NOW

Betty S. W. Graumlich
Partner, Richmond
+1 804 344 3456
bgraumlich@reedsmith.com

Anne E. Witt
Summer Associate
+1 804 344 3431
awitt@reedsmith.com

Assistant bank managers came up short in their recent efforts to cash in on claimed lost overtime compensation under the Fair Labor Standards Act. In April, a Pennsylvania jury determined that Citizens Financial Assistant Managers are not entitled to be paid overtime for hours worked in excess of 40 hours in a workweek because they are supervisors (*Bell v. Citizens Financial Group Inc. et al.,* U.S. District Court, Western District of Pennsylvania, No. 2:10-cv-00320). This decision represented an important victory for banking institutions around the country overwhelmed with similar lawsuits in the past several years. (See *Osborne v. Nicholas Fin., Inc.*, Middle District of Tennessee, No. 2013 U.S. Dist. LEXIS 39004; *Ross v. RBS Citizens, N.A.*, 667 F.3d 900 (7th Cir. 2012)). The *Citizens Financial* jury verdict, however, does not put this issue to rest.

In the past decade, class action lawsuits alleging wage and hour violations have exploded. According to CNNMONEY.com, lawsuits involving wage and hour claims have increased more than 400 percent in the past 11 years, and assistant managers in all industries continue to obtain rulings allowing them to bring class action lawsuits for overtime compensation.

Although the banking industry has remained relatively unscathed to date, this success has resulted largely from procedural victories. For example, in February, JPMorgan Chase successfully defeated an overtime lawsuit filed by one of its assistant branch

managers on grounds that the assistant manager had signed an arbitration agreement at the time of her employment. (*Ryan v. JPMorgan Chase & Co.*, 2013 U.S. Dist. LEXIS 24628.) Just last month, both PNC and Citizens Financial scored victories when the class certifications of the assistant branch managers were overturned. Although to date, assistant branch managers have not succeeded in getting judgments or verdicts in overtime cases, they have been successful in obtaining multimillion-dollar settlements from some financial institutions in overtime cases where the court certified a class.

Overtime compensation cases are highly fact-sensitive and dependent on the duties actually performed by assistant branch managers. All financial institutions should review their wage classification policies and practices regularly to ensure compliance with the Fair Labor Standards Act. Failure to do so could result in the piggy bank breaking.

FEDERAL AGENCIES MAKE CHANGES TO REGULATION GOVERNING THE GARNISHMENT OF DEPOSIT ACCOUNTS CONTAINING BENEFIT PAYMENTS

Joseph ("Jay") E. Spruill, III
Counsel– Richmond, VA
Financial Industry Group
jspruill@reedsmith.com

On May 29, the Treasury Department, Social Security Administration, and certain other federal agencies issued a final rule amending the regulation[1] governing the garnishment of federal benefit payments that are directly deposited to accounts at financial institutions. Financial institutions have been subject to the agencies' interim final rule since May 1, 2011. The final rule adopts the interim final rule with certain changes that will impact how financial institutions handle garnishments under the regulation. A number of these changes are in response to concerns raised by financial institutions during the comment period established by the agencies with the release of the interim final rule. The final rule is effective June 28, 2013.

Here is a summary of the changes:

Definition of Garnishment Order

The final rule revises the definition of "garnishment order" to include orders or levies issued by a state, state agency, or municipality. The definition is important because the regulation's requirements are triggered only by a financial institution's receipt of a "garnishment order." Currently, the definition of "garnishment order" is limited to an order issued by a court or a state child support agency. The change to the definition means that a financial institution that receives a tax levy directed to a deposit account must now comply with the "account review" and other requirements of the regulation.

In addition, the final rule removes any doubt as to whether the regulation applies to restraining orders by amending the definition of garnishment order to include "an order to freeze assets in an account."

The final rule also clarifies that an order "issued by a court" includes an order issued by the clerk of the court or an attorney acting in his capacity as an officer of the court in accordance with state law. Finally, the phrase "to enforce a money judgment" has been removed from the definition of "garnishment" to ensure the regulation's application is not limited to money judgments.

Definition of Benefit Payment

In order to help financial institutions properly identify a "benefit payment" under the regulation, the agencies have amended the definition of "benefit payment" to mean a direct deposit payment that not only includes an "XX" in positions 54 and 55 of the Company Entry Description field, but also includes the number "2" in the Originator Status Code field of the Batch Header Record of the direct deposit entry.

Definition of Lookback Period

Financial institutions have questioned how the account balance should be calculated when conducting an account review to determine the "protected amount." They have noted that the procedure for calculating the protected amount does not take into account intraday deposits and withdrawals. In this regard, the interim final rule defines "protected amount" as the lesser of: (i) the sum of all benefit payments posted to an account between the close of business on the beginning date of the lookback period and the open of business on the ending date of the lookback period, and (ii) the balance in an account at the open of business on the date of the account review. If the account review is performed in the afternoon, and items have been posted to the account during the day, the protected amount under clause (ii) (i.e., as of the open of business) will likely be different from the amount determined by the financial institution at the time of account review. To address this, the federal agencies have amended the definition of "protected amount" to refer to the balance in an account when the account review is performed.

Garnishment Fee

Currently, a financial institution may not charge or collect a garnishment fee against a protected amount, and may not charge or collect a garnishment fee after the date of account review. This means that a garnishment fee may be imposed only if non-exempt funds are in the account to cover such fee, and such fee is collected no later than the date of the account review.

In response to concerns raised by financial institutions regarding the time and expense of processing garnishment orders under the regulation, the federal agencies have amended the regulation to permit garnishment fees in certain additional circumstances. In particular, the rule has been amended to permit a financial institution to charge a garnishment fee for up to five business days after the account review if funds other than a benefit payment are deposited to the account within this period. Such fee may not exceed the amount of the non-benefit deposited funds.

Account Holder Notices

Currently, a financial institution must send an account holder named in garnishment order a notice if the balance in the account on the date of the account review is above zero dollars and the financial institution has established a protected amount.

A number of financial institutions pointed out that this meant that a financial institution would be required to send such notice for an account with exempt federal benefit funds even when no account funds are frozen (i.e., there are no non-exempt funds). Financial institutions noted that significant expenses are associated with preparing and mailing garnishment notices for accounts in which no funds are available for the creditor, and that customers may be confused by such notice and make inquiries with their financial institutions. Accordingly, the agencies have amended the rule to require a notice to the account holder only in cases where funds are in the account in excess of the protected amount.

Financial institutions will want to review and make adjustments to their procedures and systems to accommodate these changes by the June 28 effective date.

---

1. 31 C.F.R. § 212.1 et seq.

ReedSmith

FOURTH CIRCUIT IS THE FIRST TO HOLD ABSOLUTE PRIORITY RULE APPLICABLE TO INDIVIDUAL CHAPTER 11 DEBTORS *In re Maharaj, 681 F.3d 558 (4th Cir. 2012)*

Alison Wickizer Toepp
Associate, Richmond
+1 804 344 3465
atoepp@reedsmith.com

Case Snapshot

The Court of Appeals for the Fourth Circuit is the first court of appeals to determine whether the absolute priority rule continues to apply to individual chapter 11 debtors. Taking the "narrow view" adopted by certain courts, the Fourth Circuit held that the rule was not abrogated by the amendments of the Bankruptcy Abuse Prevention and Consumer Protection Act, and therefore affirmed the bankruptcy court's order denying confirmation of the proposed plan.

Factual Background

The individual debtors owned and operated an auto body repair shop. As the victims of fraud, the debtors were saddled with considerable debts that exceeded the statutory limits for a chapter 13 filing. Accordingly, the debtors filed a chapter 11 petition and continued to operate their business as debtors in possession. The proposed plan of reorganization involved four creditor classes, only one of which—consisting of most general unsecured claims (Class III)—would be impaired. The plan provided that the debtors would continue to operate the business and use income from the business to pay the Class III creditors. The holder of Class I and IV claims—a bank with secured (Class I) and unsecured (Class IV) claims—voted to approve the plan. A secured auto lender (the lone Class II creditor) did not vote. Only one Class III creditor returned a ballot—and voted against the plan under which it would receive 1.7 cents on the dollar over a period of five years.

The debtors sought to have the bankruptcy court cram down and approve the plan. If the absolute priority rule were to apply, the Class III dissenting creditor must be paid in full in order for the plan to be crammed down because the debtors retained property under their proposed plan. Debtors argued that the absolute priority rule did not apply to individual chapter 11 debtors, and that if the rule did apply, the debtors would be forced to liquidate their business, would lack a source of income, and would be unable to make payments to creditors. The bankruptcy court held that the absolute priority rule continues to apply to individual chapter 11 debtors, and denied plan confirmation. The debtors appealed, and the bankruptcy court, on its own motion, certified its order for direct appeal to the Court of Appeals, because the judgment involved a question of law as to which there was no controlling decision; a panel of the Fourth Circuit Court of Appeals authorized the direct appeal.

Court Analysis

The court's opinion began with a review of the judicial and statutory application of the absolute priority rule, noting that in the Bankruptcy Reform Act of 1978, Congress specifically incorporated the rule into section 1129(b)(2)(B)(ii) (this subsection allows the cram down of a plan that is "fair and equitable"). In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), amending section 1129(b)(2)(B)(ii) to read: "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest in any property, except that in a case in

which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of this section." (Emphasis added.) Section 1115, which was added by BAPCPA, provides: "(a) In a case in which the debtor is an individual, property of the estate includes, in addition to the property specified in section 541 – (1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed…."

A "significant split of authorities has developed nationally among the bankruptcy courts regarding the effect of the BAPCPA amendments on the absolute priority rule when the chapter 11 debtor is an individual." As this court described it, some courts—including the bankruptcy courts for the Middle District of Florida, the Northern District of Indiana, the District of Kansas, the District of Nebraska, the District of Nevada, and the Bankruptcy Appellate Panel for the Ninth Circuit—have adopted the "broad view" that the BAPCPA effectively abrogated the absolute priority rule when the chapter 11 debtor is an individual. Some of the "broad view" courts rest their decision on the "plain" language of section 1129(b)(2)(B)(ii), holding that by including in that section a cross-reference to section 1115, which in turn references section 541 (the provision that defines the property of a bankruptcy estate), "Congress intended to include the entirety of the bankruptcy estate as property that the individual debtor may retain, thus effectively abrogating the absolute priority rule in chapter 11 for individual debtors." Other "broad view" courts determined that "reading the amendments to section 1129(b)(2)(B)(ii) as eliminating the absolute priority rule for individual debtor would be consistent with the perceived Congressional intent to harmonize the treatment of the individual debtor under Chapter 11 with those under Chapter 13, which has no absolute priority rule."

Still other courts—including the bankruptcy courts for the Central and Northern Districts of California, the Middle District of Florida, the Southern District of Georgia, the District of Idaho, the Northern District of Illinois, the District of Massachusetts, the District of Oregon, the Eastern District of Tennessee, the Southern District of Texas, and the Eastern and Western Districts of Virginia—however, have adopted a "narrow view," holding that the BAPCPA amendments "merely have the effect of allowing individual chapter 11 debtors to retain property and earnings acquired after the commencement of the case that would otherwise be excluded under section 541(a)(6) & (7)."

The Fourth Circuit noted that some courts reached their conclusions based on what they viewed was unambiguous statutory language (both broad and narrow views), while other courts determined that the language was ambiguous, and after examining Congressional intent, concluded that Congress did intend to abrogate the rule (broad view courts), or Congress did not intend to abrogate the rule (narrow view courts).

The Maharaj court determined that the statutory language was "ambiguous because it is susceptible to more than one reasonable interpretation." The court then looked "to the specific and broader context within which Congress enacted the BAPCPA, as well as a familiar canon of statutory construction, the presumption against implied repeal," and concluded that Congress did not intend to abrogate the absolute priority rule. "We arrive at the conclusion that Congress did not intend to alter longstanding bankruptcy practice by effecting an implied repeal of the absolute priority rule for individual debtors proceeding under Chapter 11."

The court was persuaded to adopt the narrow view primarily because: (i) if Congress had intended to abrogate the long-standing application of the absolute

priority rule to chapter 11 individual debtors, it would have done so in a straightforward manner, such as by adding the words "except with respect to individuals" at the beginning of section 1129(b)(2)(B)(ii), or by simply increasing the debt limits for chapter 13 filings; (ii) there is no evidence that Congress intended to harmonize the treatment of chapter 11 individual debtors with the treatment of chapter 13 debtors; and, (iii) Congress intended that the BAPCPA amendments would improve bankruptcy law and practice by restoring personal responsibility in the system and ensuring that the system is fair for both debtors and creditors.

The court therefore affirmed the bankruptcy court's denial of plan confirmation.

Practical Considerations

As the first Court of Appeals to decide this issue, one can expect the Maharaj opinion to carry great weight, particularly in "narrow view" jurisdictions. This court took substantial care to examine both sides of the issue, as well as the history of the absolute priority rule. The court certainly charted a clear roadmap for other courts to use—or disagree with—in future cases.

William Mutterperl
Partner, New York
+1 212 549 0263
wmutterperl@reedsmith.com

CRA and Disparate Impact Now More Muddled Than Ever

A recent enforcement action by the OCC applies disparate impact theory in finding that a group of white borrowers had been discriminated against, creating a mine field for financial institutions.
Click here to learn more.

Reproduced with permission from BNA's Banking Report, 100 BBR 97 (May 28, 2013).
Copyright 2013 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com