v. Federal Insurance Co., 674 N.W.2d 617 (Wis. Ct. App. 2003), and an Illinois appellate court third-party contract liability case, *RBC Mortgage Co. v. National Union Fire Insurance Co. of Pittsburgh*, 812 N.E.2d 728 (Ill. App. Ct. 2004), reasoning that Wisconsin would extend the majority rule to the contract liability context as a "logical extension" of *Tri City*. The court concluded that Universal's loss in this case was not a direct result of its employee's misconduct, but rather stemmed from the contractual requirement that it repurchase non-compliant loans from the investors. The court rejected Universal's argument that its loss was based on its initial funding of the non-compliant loans—made solely because its employee's dishonesty ensured the loans were deemed compliant—reasoning that Universal recouped such loss when it sold the loans to investors. Accordingly, the court held that the fidelity bond did not cover the contract liability that led to Universal's claim.

Even if Universal's claims were covered, the court concluded that the fidelity bond's exclusion for loss resulting from any repurchase of real estate loans precluded coverage. Although the court recognized that the underlying cause of Universal's loss may have been employee dishonesty, it held that the exclusion precluded coverage where, ultimately, Universal's loss was the result of its repurchase of real estate loans.

National Banks

Risk Management

Changes to Federal Preemption Standards and State Visitorial Powers Under Dodd-Frank are Likely to Mean More Enforcement Actions: 10 Steps Your Company Should Take When Responding to a Subpoena



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- **Federal preemption standards have been altered by case law in the past five years.**
- **Enforcement actions may increase as a result of oversight changes led by the Dodd-Frank Act.**
- **Without a director, the role and powers of the Consumer Financial Protection Bureau will be somewhat limited.**

Federal preemption standards and state visitorial powers have undergone significant changes in the past fifteen years, most recently with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act).[1] The Dodd-Frank Act's codification of *Barnett Bank*[2] and *Cuomo*[3] will likely impact how State Attorneys General interact with banks and other financial service providers. In addition to the federal preemption and visitorial powers changes, the Consumer Financial Protection Bureau (CFPB) will soon establish itself as a major enforcement force. This combination of factors will likely lead to an increase in the number of enforcement actions brought against financial service providers and their officers and directors. As such, it is even more critical that companies understand the procedures and take the appropriate steps when preparing for and responding to a subpoena, civil investigative

demand, or similar request for information, regardless of whether the request emanates from the Department of Justice, a state attorney general, or the CFPB.

Changes to Federal Preemption and Visitorial Powers

The Dodd-Frank Act made several significant changes to the rules and procedures relating to federal preemption for national banks and federal thrifts. Most notably, the law clarified the preemption standards applicable to national banks by codifying the standard adopted by the Supreme Court in *Barnett Bank*.[4] In addition, the Dodd-Frank Act repealed the broad field preemption doctrine previously applicable to federal thrifts and applies the same standards applicable to national banks. Further, it repealed the federal preemption rights previously enjoyed by operating subsidiaries of national banks and federal thrifts. Under the *Barnett Bank* standard codified by the Dodd-Frank Act, a state law will only be preempted to the extent that it "prevents or significantly interferes" with the exercise of the national bank's powers.[5] Previous regulatory language purported to preempt state laws that "obstruct, impair or condition" the exercise of a bank's federally authorized powers.[6] A robust debate has emerged as to whether, and how, preemption will differ post-Dodd-Frank Act, as evidenced by the public comment letters filed in response to the Office of the Comptroller of the Currency's (OCC) proposed preemption regulation revisions.[7]

Regardless of the extent to which the legal standard for preemption changes as a result of the Dodd-Frank Act, key procedures for making preemption determinations have also changed and many are concerned that states and state enforcement agencies will be emboldened to more aggressively seek the application of state laws to national banks and federal thrifts. The Dodd-Frank Act requires OCC to make preemption determinations on a case-by-case basis upon a showing of "substantial evidence" and has lowered the deference given to OCC when making preemption determinations, making it harder for OCC to give preemption guidance. Moreover, the Dodd-Frank Act codified the Supreme Court's *Cuomo* decision to further extend the role State Attorneys General will play in enforcement actions targeting financial service providers.[8] The Supreme Court in *Cuomo* upheld the OCC's definition of visitorial powers within the National Bank Act (NBA), concluding that State Attorneys General could not inspect or subpoena national banks in the role of "supervisor of corporations."[9] However, the Court held that the OCC did not have exclusive authority to supervise national banks when it came to enforcement actions alleging violations of state law.[10] The codification of *Cuomo* allows State Attorneys General to take legal action to enforce non-preempted state laws. State Attorneys General are likely to be encouraged by Congress's endorsement of their role in enforcing non-preempted state laws through legal action and may seek opportunities to bring enforcement actions against national banks and other financial services firms they believe to be violating applicable state law.

Additionally, these cooperative efforts should create efficiencies for states which will enhance their ability to enforce their own consumer finance laws.

Effect of the Consumer Financial Protection Bureau

Reduced restrictions on the enforcement powers of State Attorneys General is not the only aspect of the Dodd-Frank Act likely to increase enforcement actions targeting financial service providers. The creation of the CFPB tasks an agency to work as a consumer advocacy group enforcing federal consumer financial laws. In addition to the CFPB's role within federal enforcement, the agency has also stated an intention to assist State Attorneys General in state level enforcement actions. In a Memorandum of Understanding between the CFPB and the Conference of State Bank Supervisors, the CFPB has agreed to exchange information gathered from consumer complaints and from CFPB compliance reviews. This agreement to share information will provide state officials with a level of information that they currently do not have access to or the resources to obtain on their own. With the nomination of former Ohio Attorney General Richard Cordray as the director of the CFPB, cooperation between the CFPB and State Attorneys General will likely increase as well. Such cooperation seems likely to lead to more coordinated investigations and enforcement actions being brought against financial service providers. Additionally, these cooperative efforts should create efficiencies for states which will enhance their ability to enforce their own consumer finance laws.

An important aspect to consider when discussing the CFPB is the fact that the director was not in place as of July 21, 2011, the date on which the agency opened for business. Although the President has nominated Richard Cordray to become the director, his

nomination is not at all assured given the significant opposition expressed by Senate Republicans to any nomination absent structural changes in the organization of the CFPB. Until a director is confirmed by the Senate, the role and powers of the CFPB will be limited to some degree. While there is currently a debate as to the powers held by the CFPB without a director, the Joint Response by the Inspectors General of the Treasury Department and the Board of Governors of the Federal Reserve provided Congress with their interpretations under the Dodd-Frank Act.[11] The Joint Response stated that even without a director, the CFPB would have the ability to "conduct examinations (for federal consumer financial law purposes) of banks, savings associations, and credit unions with total assets in excess of $10 billion, and any affiliates thereof."[12] Additionally, while some functions of the CFPB may be limited (specifically certain rulemaking functions), the CFPB will be able to pursue enforcement actions regarding any current "orders, resolutions, determinations, agreements, and rulings" affecting the same group of larger institutions.[13] While the lack of a director does limit the institutions that the CFPB can target, the larger banks will still be under the authority of the CFPB.

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One possible consequence of limitations on the CFPB's rulemaking authority is an increased focus on enforcement actions. Many have expressed the concern that absent the ability to write prospective regulations, the CFPB may view enforcement actions as its most effective tool to accomplish its mission, in effect rulemaking by litigation. In an article from June 2011, Jeremiah Buckley noted that he was "afraid that the temptation will be to proceed by way of enforcement actions, to go after what are perceived violations."[14] The CFPB has already indicated its intention to cooperate and collaborate with State Attorneys General and state regulatory agencies on enforcement actions through the adoption of specific agreements with these enforcement officials. Thus, the potential exists for financial services firms to face multi-layer enforcement actions and be subject to overlapping subpoenas and information requests from federal and state enforcement agencies. Even if discovery demands are not multiplied as a result of coordination, the information sharing among enforcement agencies will increase the leverage of the government to obtain settlements on disadvantageous terms to financial services firms.

Responding to a Subpoena? Here are 10 Things Your Company Should Do Immediately

Any increase in investigations and enforcement actions involving banks and financial services providers would involve an increase in the frequency and possibly the scope of subpoenas. Financial services providers should ensure that the processes in place for responding to subpoenas are up-to-date, and that, if a subpoena is received, the response is quick and diligent. Responding to a subpoena can be a daunting task and early missteps can have severe repercussions. Legal departments should have policies and procedures in place in the event government prosecutors come knocking. Below is a short list of critical steps financial services firms can take in the early stages of the subpoena response to protect themselves.

1. Preserve. Preserve. Preserve. Destroying or removing documents in the context of a government investigation–whether done affirmatively or by failing to suspend automated document retention protocols–may be viewed as obstruction of justice. At the very least, it will create the appearance of an unwillingness to cooperate with the investigation. Immediately upon receipt of a subpoena, the company should inform all necessary employees of the need to retain documents, including electronic documents, with a document hold memo that replaces standard document retention policies for potentially responsive materials.
2. Establish a dialogue with the appropriate enforcement authorities. Communication at an early stage is critical to understanding the scope of the investigation and establishing a sound working relationship with the government. Company counsel should initiate contact quickly to discuss the scope of the subpoena and develop a feasible production schedule.
3. Inform the company's key executives. Receiving a subpoena is no small matter and, depending on the nature of the subpoena and potential enforcement action, the key executives and even the board of directors should be made aware immediately. This is especially important if your company is publicly traded as there may be disclosure obligations.
4. Determine whether the subpoena was properly served. Not all subpoenas are properly served and improper service may provide valid grounds to get the subpoena quashed.

Company counsel should quickly evaluate the basis upon which the subpoena was issued and served to determine whether to object or take other action.

5. Advise employees of their rights and responsibilities, including access to counsel. Either at the time the subpoena is initially served or in subsequent follow up activities, agents may attempt to interview employees. It is important to remind employees immediately of their responsibility to be truthful when speaking with agents of the government, but that they may chose to have an attorney present if they do decide to be interviewed. You should also reiterate your company's policy on cooperating with investigations and request that employees inform the legal department of any discussions or contacts with the government.
6. Evaluate your insurance policy's notice requirements. Under many insurance policies, a subpoena is a triggering event. Putting your policy holder on notice early on increases your chances of having insurance pay for some or all of the investigation and/or litigation costs.
7. Identify key company individuals. Identifying which individuals within the company are key to the subpoena response will help determine and potentially limit the overall scope of documents you are required to produce. Seeking to narrow or tailor the scope of a subpoena is an important early step in the response process.
8. Narrow file search parameters. Once the key individuals are identified, company counsel can then identify electronic and paper files that must be collected and searched. Fulfilling the government's request but not producing irrelevant or privileged documents requires a precisely-tailored search protocol.
9. Protect and Defend Privileged Materials. Protecting and defending privileged materials is a cornerstone responsibility of corporate counsel. Documents subject to privileges or protections should be isolated, logged, and preserved. While there are remedies available for inadvertently-produced privileged materials, no one wants to be in the position of having to seek return of a privileged document.
10. Construct a formal, defensible review process. Company counsel should construct a formal review process that can be defended in court, with a focus on e-discovery issues. It is advisable to have the company's response protocol evaluated by outside legal counsel early in the process to ensure that all potential sources of electronic data have been identified and searched.

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[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank Act).

[2] *Barnett Bank v. Nelson*, 517 U.S. 25 (1996).

[3] *Cuomo v. Clearing House Assn., L.L.C.*, 129 S. Ct. 2710 (2009).

[4] Dodd-Frank Act, § 1044(a).

[5] *Id.*

[6] *See* 12 C.F.R. §§ 7.4007, 7.4008, and 34.4.

[7] 76 Fed. Reg. 30557 (May 26, 2011).

[8] Dodd-Frank Act, § 1047.

[9] *Cuomo*, 129 S. Ct. at 2721.

[10] *Id.*

[11] Joint Response by the Inspectors General of the Department of the Treasury and Board of Governors of the Federal Reserve System, Enclosure 5-6 (Jan. 10, 2011).

[12] *Id.* at 5.

[13] *Id.* at 6.

[14] Josh Boak, *Consumer Financial Protection Bureau can open without Chief*, Politico, June 16, 2011, http://www.politico.com/news/stories/0611/57142.html.