Message from Our Managing Partner

In this issue we focus again on business.

First, we provide an update on cases recently filed in the Delaware Court of Chancery, which similarly claim that certain forum selection bylaw amendments are unconstitutional.

We also provide a roundup of means by which government and class action cases are targeting and seeking injunctions against some actions of payment processors.

And we report on the Consumer Financial Protection Bureau’s new supervision and examination process, and on its proposed reporting rule that raises concerns about potential erosions of attorney-client privilege.

We also have accolades to note: We’ve received a prestigious award for our commitment to diversity, and we proudly announce the Wilmington office lawyers honored by Chambers and Super Lawyers this year.

As always, we welcome your comments, your questions, and your suggestions for this newsletter.

David B. Stratton, Managing Partner

Pepper Hamilton Receives MCCA’s ‘Thomas L. Sager Award’ for Commitment to Diversity

Firm Recipient of 2012 Award for the Mid-Atlantic Region

Minority Corporate Counsel Association (MCCA) has named Pepper Hamilton LLP as the winner of the distinguished 2012 Thomas L. Sager Award for the Mid-Atlantic Region.

The prestigious Sager Award is presented annually to one firm, in each of MCCA’s five regions, that has demonstrated a sustained commitment to improve the hiring, retention and promotion of minority attorneys. In addition to the statistical data that is set forth in the nomination application, the Board of Directors examine such areas as recruitment, retention, mentoring, promotion, pipeline initiatives, LGBT initiatives, women initiatives, work-life balance, collaborative efforts with community and bar associations, and innovative practices that result in sustainable efforts to increase diversity.

“I recently joined Pepper in February and it was clear to me that the firm—from the leadership down the line to individual lawyers and staff—understood that diversity means not only retaining diverse attorneys but more importantly taking advantage of the full breadth and depth of the experiences, education, cultural knowledge and viewpoints of all of our people” said Pepper CEO Scott Green, accepting the award on behalf of the firm. “We recognize that the more diverse we are, the more...
viewpoints we are likely to have to service our clients and do well in our communities."

Pepper was announced as the winner at the MCCA Regional Networking Forum on June 5, 2012 at the Newseum in Washington, D.C. The program featured a panel presentation of local legal leaders that discussed how fascinating life experiences have impacted their careers. Following the panel presentation and award announcement, the evening concluded with a networking reception.

Partner Kassem Lucas is in charge of Pepper Hamilton’s firm-wide diversity initiatives and programs and also co-chairs the firm’s Diversity Committee, which was established in 2005. “As an attorney who has spent his entire legal career at Pepper Hamilton, from summer associate to partner, and was recently named the firm's Partner in Charge of Diversity, I am not just a proponent of the firm’s diversity and inclusion efforts: I am a product of them,” said Lucas.

The Sager Award was established by the MCCA to honor Thomas L. Sager, DuPont Company’s senior vice president and general counsel and MCCA Board member, in recognition of his individual efforts and relentless commitment to promote diversity in the legal profession.

Coincidentally, Sager was the recipient of Pepper Hamilton’s 2011 Champion of Diversity award.

ABOUT THE MINORITY CORPORATE COUNSEL ASSOCIATION

The Minority Corporate Counsel Association, Inc. was founded in 1997 to advance the hiring, retention, and promotion of diverse attorneys in legal departments and the law firms that serve them. MCCA accomplishes its mission through the collection and dissemination of information about diversity in the legal profession.

Chambers and Super Lawyers 2012

Four lawyers from Pepper’s Wilmington office have been recognized as leaders in Delaware law in the 2012 edition of Chambers USA: America’s Leading Lawyers for Business. Profiled in their practice area are Donald J. Detweiler, David M. Fournier and David B. Stratton (bankruptcy/restructuring) and Christopher J. Lamb (real estate). Our bankruptcy practice also is highly ranked among Delaware law firms. Chambers and Partners’ guides provide independent rankings and commentary reflecting market opinion, ranking lawyers, law firms and practice areas based on their reputation among peers and clients. Listings are unpaid, and not all practice areas are ranked in all states. Chambers USA researchers interview thousands of lawyers and clients nationwide to assess qualities including technical legal ability, professional conduct, client service, commercial awareness/astuteness, diligence, and commitment.

Mr. Detweiler and Mr. Stratton also have been included on the 2012 Delaware Super Lawyers list and Albert H. Manwaring, IV and Bradley W. Voss have been included on the 2012 Delaware Rising Stars list. For Super Lawyers, a statewide survey of lawyers in practice for at least five years leads to nominations of the best attorneys they have observed in action. Candidates also are added from searches by an attorney-led research staff for those who have certain honors or achievements. Researchers examine candidates’ background and experience. Point totals are calculated from the balloting and qualitative evaluation steps. Candidates are grouped according to primary area of practice. Members of a blue-ribbon panel, selected from those with high point totals, review candidates from their practice area. Finalists are those with the highest point totals from each category. Only 5 percent of the lawyers in a state are selected. The Rising Stars selection process is the same, except that: 1) a candidate must be either 40 years old or younger or in practice for ten years or less and 2) Rising Stars candidates do not go through peer evaluation by practice area.
An Update on the Forum Selection Bylaw Cases

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In February 2012, several purported class action lawsuits were filed in the Delaware Court of Chancery challenging corporate bylaw amendments adopted by companies pursuant to 8 Del. C. § 109. Generally speaking, the challenged bylaw amendments would require that certain types of corporate law claims by shareholders be brought and resolved in the Delaware Court of Chancery, and not elsewhere. In the Delaware class actions, the shareholder plaintiffs sued a dozen companies, as well as members of their respective boards of directors. Each of the cases was assigned to Chancellor Leo E. Strine, Jr.

The complaints in the various actions are similar. Plaintiffs allege that the forum selection bylaw amendments are invalid under Delaware and other law, that they violate shareholder rights because they were adopted by boards of directors without the consent of the shareholders, and that the directors who adopted the bylaw amendments violated their fiduciary duties.

Of the 12 companies that were sued, the majority repealed the challenged bylaw prior to the deadline for responding to the complaint. In those cases, the parties stipulated that the claims were moot, and the actions were dismissed.

In contrast, Chevron answered the complaint, but only after revising its forum selection bylaw to allow for certain litigation to occur in another court or jurisdiction, if the Court of Chancery were to lack jurisdiction over the subject matter or over an indispensable party. The preface to Chevron’s 55-page answer may provide a glimpse into its litigation strategy: “The bylaw does not take any rights away from any shareholder. Instead, like all bylaws at all Delaware corporations, the forum selection bylaw merely regulates the way in which certain rights are exercised. … The board’s actions were well informed and taken with the shareholders’ best interests in mind. … Defendants intend to defend themselves and the forum-selection bylaw vigorously.” Thus, it appears that Chevron will go forward with discovery, and possibly trial, over its adoption of the forum selection bylaw amendment.

Those interested in the Court of Chancery’s thoughts on the validity of forum selection provisions may not need to wait for the conclusion of the potentially lengthy process embarked upon by Chevron, however. The court’s views may emerge in the context of pre-trial motion practice, or in post-dismissal fee application proceedings in the cases that were dismissed as moot. If the plaintiffs’ lawyers seek a fee, the court likely will need to assess, among other things, whether plaintiffs’ claims were meritorious when filed and whether a benefit has been conferred on the corporation. In addition, on April 9, 2012, an action was filed in the Court of Chancery seeking to block a May 2012 shareholder vote on whether to amend a company’s certificate of incorporation (not its bylaws) to include a forum selection provision. The court may touch on the merits of that dispute in the context of the plaintiff’s request for interim relief, or otherwise.

Hopefully, developments in these cases will provide the court with an opportunity to speak on this important area of corporate governance. If so, a further update will follow.

If you have any questions, please contact the author.

ENDNOTES

1 The impetus for the adoption of such forum selection bylaw amendments is likely found in the perception that lawyers for shareholder-plaintiffs sometimes sue in jurisdictions other than Delaware, even on matters governed by Delaware law, to take advantage of courts that are less familiar with Delaware corporate law. Some view the inclusion of a forum selection clause in a corporation’s constitutional documents as a way to ensure that Delaware law issues affecting a Delaware corporation will be resolved by Delaware judges, and thus reduce the potential for disruptive, costly, and duplicative multi-jurisdictional shareholder litigation. See generally In re Revlon, Inc. Shareholders Litigation, 990 A.2d 940, 960 (Del. Ch. 2010) (suggesting in dicta that an exclusive forum clause in a certificate of incorporation would be an appropriate response to shareholder suits in other jurisdictions). Many Delaware corporations have adopted forum selection bylaws in one form or another, but no Delaware court has directly addressed whether such provisions are valid.
Over the past year, the Federal Trade Commission (FTC) and the Federal Deposit Insurance Corporation (FDIC) have issued guidance to financial institutions and payment processors regarding risks associated with merchant banking (see Pepper’s February 3, 2012 Financial Services Alert, “FDIC Focuses on Payment Processing Programs at Community Banks: Is Your Compliance Sufficiently Robust?” available online at http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2291).

It has been reported publicly that the FDIC has brought enforcement actions that have resulted in formal cease and desist orders and monetary penalties against insured depository institutions, and the FTC has actively sought injunctions against participants in allegedly unlawful payment processing activities. Recently, a federal judge has found that a plaintiffs’ class action lawsuit has sufficiently pled facts to state a claim against Zions First National Bank (Zions) and several payment processors for private racketeering violations in connection with their relationships with allegedly fraudulent telemarketing schemes. (See Reyes v. Zions First National Bank, et.al. Civil Action No. 10-345, 2012 BL70261 (E.D. PA. Mar 21, 2012)). The allegation supporting the RICO claim included that Zions and the payment processors “...served independent and crucial roles in conducting an enterprise with the common purpose of earning fees for facilitating fraudulent telemarketing schemes ... and ... pleads facts showing that Zions Defendants ... were aware of several blatant indications of fraud, including ... staggeringly high rates of ACH returns, and in particular, rates of return for lack of authorization ... Reyes also sufficiently pleads a pattern of such racketeering activity by the Zions Defendants.”

The court also looked at ongoing government enforcement activity, particularly one by the Iowa attorney general against one of the defendants for having “... assisted fraudulent telemarketers by performing essentially the same function ... as are alleged to have been performed in this case.”

A violation of a RICO statute can result in treble damages and attorneys’ fees, and the reputational risk associated with being a defendant in such a case is significant.
CFPB Issues Proposed Rule on Privileged Information Obtained from Supervised Entities and House Passes Bill that Would Authorize It, But Concern Remains About Erosion of Attorney-Client Privilege

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On March 12, 2012, the Consumer Financial Protection Bureau (the Bureau) announced a proposed rule (the Proposed Rule)\(^1\) to codify protections for privileged information obtained by the Bureau from financial institutions and other entities it supervises.\(^2\) The Proposed Rule provides that any supervised entity that submits privileged material to the Bureau (such as communications with counsel) in the course of the supervisory process does not waive the privilege. On March 26, 2012, the House of Representatives passed H.R. 4014, a bill that if enacted into law would provide clear statutory authority for the Proposed Rule. Serious concern remains, however, that even if authorized by statute the Bureau’s policy of requiring supervised entities to provide privileged material to the Bureau, even without waiver of privilege, will ultimately result in erosion of the attorney-client privilege.

The Proposed Rule came about because of controversy generated by Bulletin 12-01, which the Bureau issued on January 4, 2012. In Bulletin 12-01, the Bureau advised institutions that it supervises that, upon request, they must disclose privileged material to it. The Bureau also gave its assurance that such disclosure would not result in a waiver of privilege because the submission of privileged material was involuntary.\(^3\)

Bulletin 12-01 caused a hubbub in legal and business circles because of the serious consequences if the Bureau’s assurance turns out to be unfounded. Waiver of privilege means that the confidential communications a client shared with its lawyers in reliance on the attorney-client privilege could end up in the wrong hands and actually be used against the client. Concern was also expressed that the Bureau’s position might in fact be unfounded. Specifically, the Bureau’s position appears to conflict with 12 U.S.C. § 1828(x) – the statute that provides that the submission of information to a “Federal banking agency” shall not be construed as waiving, destroying, or otherwise affecting any privilege.”\(^4\) “Federal banking agency” is a defined term that

What You Need to Know About Working with the CFPB Supervision and Examination Process

The Consumer Financial Protection Bureau (CFPB) recently issued version 1.0 of its Supervision and Examination Manual. The manual is the CFPB’s guide on how it will exercise the supervision and examination powers given to it by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The techniques found in the manual are currently being applied to supervise and examine consumer financial service providers for compliance with federal consumer financial law.

Recently, Pepper Hamilton hosted an interactive webinar on what to expect from the CFPB’s examinations of consumer financial service providers and explain useful techniques and other considerations when interacting with the CFPB and its supervision and examination teams. Pepper partner and former Delaware Bank Commissioner Timothy R. McTaggart discusses what was covered during this timely webinar available on Pepper’s Web site at www.pepperlaw.com/news.aspx?AnnouncementKey=1437.
clearly does not include the Bureau. Notably, when Congress passed the Dodd-Frank Act, which created the Bureau, it did not amend the definition of “Federal banking agency” to include the Bureau.

Against this backdrop, the Bureau came out with the Proposed Rule, which “is intended to govern all claims, in Federal and State court, that an entity has waived any applicable privilege by providing information requested by the Bureau pursuant to its supervisory or regulatory authority.” According to the Bureau, it “continues to adhere” to the position it took in Bulletin 12-01, “that the submission of privileged information in response to requests made pursuant to the Bureau’s examination authority does not result in a waiver of any privilege with respect to third parties.” Nonetheless, it decided to exercise its rule-making authority “in order to provide maximum assurance to its supervised entities ....”

In addition to providing that any supervised entity that submits privileged material to the Bureau in the course of the supervisory process does not waive the privilege, the Proposed Rule also provides that the Bureau’s provision to another federal agency or a state agency of privileged material received from a supervised entity does not waive the privilege. Unlike Bulletin 12-01, the Proposed Rule clearly applies to all entities subject to the Bureau’s supervisory authority. In Bulletin 12-01 the Bureau made reference only to banks.

The million-dollar question is whether the Bureau has the authority to enact the Proposed Rule. As support for its rulemaking authority, the Bureau has stated that it relied on:

- its authority to “prescribe rules regarding the confidential treatment of information obtained from persons in connection with the exercise of its authorities under Federal consumer financial law”
- its general rulemaking authority to prescribe rules it determines are “necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof;” and
- its authority to “prescribe rules to facilitate the supervision of [nondepository institutions] and assessment and detection of risks to consumers.”

The Bureau construes these statutory sources as indirectly giving it a power that Congress did not give it expressly when it passed the Dodd-Frank Act.

After the Bureau announced the Proposed Rule, the House passed H.R. 4014. This bill was one of several introduced to give the Bureau clear authority to request and receive privileged material from supervised entities without resulting in a waiver of the privilege. H.R. 4014 would amend 12 USC sections 1821(t)5 and 1828(x) to add the Bureau to the statutory definition of “Federal banking agency.” Like the Proposed Rule, H.R. 4104 would apply all entities subject to the Bureau’s supervisory authority, not just depository institutions. H.R. 4104 is expected to pass the Senate.

Pepper Points

Unless and until the Senate passes H.R. 4014, it remains to be seen whether the Proposed Rule, assuming it becomes final, can withstand judicial scrutiny. In our view, there is a reasonable possibility that a reviewing court would hold that, if Congress had intended for the Bureau to be able to obtain privileged information from supervised entities without resulting in a waiver of privilege, it would have amended the statutory definition of “Federal banking agency.” As a result, absent a legislative solution, supervised entities faced with a request from the Bureau for privileged material will find themselves in a dilemma – comply with the request and risk waiver of the privilege or defy the Bureau and risk administrative sanctions and the prospect of an angered regulator. One option would be to work with the Bureau as much as possible to limit and narrow the request for privileged material, and if the entity is regulated by a Federal banking agency, coordinate disclosure through the bank regulator as part
of a joint examination process. Another option would be to seek a judicial ruling, but that comes with cost and uncertainty too. Clearly a legislative solution like H.R. 4014 would address these problems.

But behind the issue of statutory authority lies a deeper and more troublesome problem – whether the Bureau should have unfettered power to force supervised entities to hand over privileged materials. It seems likely or even inevitable that the Bureau or other federal or state agencies to which it transfers privileged material will use that privileged material against the entity that provided it or at the very least to the detriment of that entity. We are concerned that this will result in a serious erosion of the attorney-client privilege.

This concern is heightened for nonbank entities, which before the Dodd-Frank Act were never subject to the supervision of any Federal banking agency. Nonbank entities are different in many ways from banks. Among other things, nonbanks do not receive the federal support provided to banks and other depository institutions in the form of FDIC deposit insurance. Regulators at Federal banking agencies typically insist that non-governmental third parties seeking confidential information from banks through discovery or subpoenas enter into agreements protecting and maintaining legally recognized privileges, particularly sensitive bank information associated with an examination. We question whether nonbank entities supervised by the Bureau should receive less legal protection.

We are also concerned that the Bureau has set no standards for when it may demand the disclosure of privileged material. Theoretically, the Bureau could request material concerning a supervised entity’s plans to sue the Bureau or defend itself from Bureau action, and since the request could bear on areas broadly covered by the Bureau’s jurisdiction, beyond what would typically be requested in an examination by a Federal banking regulator, the Proposed Rule could result in a total abrogation of privilege.

We are further concerned that there may be a privilege “gap” if the Bureau discloses to state agencies – such as state banking agencies or attorneys general – privileged material it obtained from supervised entities. Traditionally, federal regulators have relied on Memoranda of Understanding (MOUs) when sharing privileged information with state authorities. The Bureau has entered into an MOU with the Conference of State Bank Supervisors. While it provides that the sharing of nonpublic information pursuant to the MOU will “in no way constitute[ ] a waiver of ... any applicable privileges,” it also states that “[n]o provision of this MOU is intended to, and no provision of the MOU shall be construed to, limit or otherwise affect the authority of a party to administer, implement, or enforce any provision of Federal consumer financial law or State consumer protection law.” This kind of ambiguous language could present a loophole for the use of privileged material by a state agency against the entity that provided it to the Bureau. In general, we think that disclosure of privileged material to the Bureau is a risky proposition, made riskier still by the prospect that the privileged material could then be transferred to a state agency outside the control of the Bureau.

Persons or entities concerned about the Proposed Rule may wish to submit comments by April 16, 2012.

ENDNOTES

1 Available at http://files.consumerfinance.gov/f/201203_cfpb_Proposed_Rule_Privileged_Information.pdf.

2 The Bureau supervises banks, thrifts, and credit unions with more than $10 billion in assets and their affiliates and service providers as well as certain nondepository (nonbank) entities that offer or provide to consumers: (1) origination, brokerage, or servicing of residential mortgage loans secured by real estate, and related mortgage loan modification or foreclosure relief services; (2) private education loans; and (3) payday loans. In addition, the Bureau has the authority to supervise any “larger participant of a market for other consumer financial products or services,” as defined by rule by the Bureau. On February 8, 2012, the Bureau issued a proposed rule to establish the initial larger participant rule for two markets: consumer debt collection and consumer reporting. The Bureau also supervises service providers of nonbank entities that are subject to the Bureau’s supervision.


4 12 U.S.C. § 1828(x) provides that “[t]he submission by any person of any information to any Federal banking agency ... for any purpose in the course of any supervisory or regulatory process of such agency ... shall not be construed as
waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information ...”

5 12 U.S.C. § 1821(t) provides that certain federal agencies, including “Any Federal banking agency,” may share privileged information with each other without waiving any privilege that may apply to that information.
