# Banking Update

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## My Collateral Includes a Commodity Account. Now What?

Prices for agricultural commodities fluctuate. A producer attempts to mitigate this price risk through hedging. A lender attempts to mitigate the risks of loaning money to the producer by taking a security interest in producer's commodity hedging accounts. The commodity broker provides the lender with a control agreement, and says that it is the "standard form" signed by all lenders. No changes needed.

It all sounds so simple, right? Not necessarily.

A commodity account control agreement is a crucial document for an agricultural lender whose collateral includes a commodity account and the securities, cash and other investment property held in the account (hereinafter referred to as, "Account Property"). Utilizing a "standard form" prepared by the commodity broker, without analyzing the provisions of the control agreement, can create unnecessary risks on a lender. This article provides a brief overview of the purpose of a control agreement, and "standard" provisions that should be avoided.

Pursuant to Article 9 of the UCC, a commodity account and the assets held in that account are investment property. To perfect its security interest, a lender should take "control" of the commodity account and the Account Property. Control of a commodity account and the Account Property exists if the commodity broker has agreed in writing that it will comply with the lender's instructions regarding the transfer or redemption of the Account Property without the consent of the owner of the account. Therefore, for purposes of perfecting a security interest in the commodity account and the Account Property, the control agreement must (1) be executed by the commodity broker, account holder, and lender, (2) accurately describe the account and the Account Property, and (3) include a provision similar to

### Also in this issue

3 Keeping Current: Best Practices for Garnishment of Bank Accounts to Collect Debts

5 FFIEC Issues Proposed Guidance on Social Media

the following:

> "Lender is authorized, without further authority from debtor, to request broker to remit to lender any funds that may be due to debtor or to direct the transfer, liquidation, or redemption of any of the Account Property. Broker is authorized to pay to lender such sums, and to comply with lender's request to transfer, liquidate or redeem any of the Account Property, all without the consent of or notice to debtor."

*There are two provisions in the typical broker-prepared control agreement that are particularly problematic and create undue risks to lender—the broker's right-to-payment provision and the margin call provision.*

The typical control agreement, however, includes more than just the broker's agreement to honor lender's instructions described above. It often establishes additional rights and obligations of the account holder, broker and lender with respect to the account and the Account Property. There are two provisions in the typical broker-prepared control agreement that are particularly problematic and create undue risks to lender—the broker's right-to-payment provision and the margin call provision.

It is standard industry practice to pay a broker's commissions and fees from the cash in a commodity account and for a broker to have a lien on the account and the Account Property to secure such payment. The typical broker-prepared control agreement, however, goes well beyond this with a provision similar to the following:

> "The security interest of lender in and to the commodity account and the Account Property is subject to the prior payment of all indebtedness of debtor to the broker as such may exist from time to time, including fees and commissions, which may have been incurred in connection with debtor's transactions with Broker, and to the broker's lien, and the right of foreclosure thereof in connection with any indebtedness of debtor to broker…"

The problem with the underlined language is that the term "indebtedness" includes all obligations owing from debtor to broker, not just fees and commissions. By agreeing to this type of language, the lender puts itself in second position behind the broker who, upon liquidation of the Account Property, will be entitled to be paid in full for all "indebtedness" owing from debtor to broker. To avoid this result, the lender should require the broker to revise the control agreement to limit the "indebtedness" of debtor to broker that has priority over the lender. We recommend the following:

> "Notwithstanding any provision contained herein to the contrary, (a) the term "indebtedness" as used in this paragraph shall not include any loans, advances or other extensions of credit from broker to debtor and (b) broker shall have no right of set-off in connection with any such loans, advances or other extensions of credit from broker to debtor."

It is also possible for a broker to make margin calls on the debtor. The typical broker-prepared control agreement takes this one step further with the following provision:

> "If the commodity broker requires additional margin for an open position, lender shall advance to the commodity broker on behalf of the debtor such amounts as may be required by the commodity broker to margin such position."

The use of the word "shall" creates a mandatory obligation on the lender to advance funds to cover a margin call by the commodity broker. There may be instances—particularly if the borrower is in default—under which the lender does not want to make such advances. If the lender enters into a control agreement with the "shall advance" provision and then refuses to make an advance, the lender risks the broker making a claim against it for breaching the contract. To avoid this risk, the lender's obligation to make margin calls should be optional, rather than mandatory. We suggest language similar to the following:

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"If the commodity broker requires additional margin for an open position, lender may, but shall not be obligated to, advance to commodity broker on behalf of debtor such amounts as may be required by commodity broker to margin such position provided, however, that debtor in all respects shall remain liable to the lender for any amount so advanced."

In summary, a commodity account control agreement is more than just "words on paper". It perfects the lender's security interest in the account and the Account Property, and just as importantly it establishes the lender's rights and obligations with respect to the account and Account Property vis-à-vis the broker. Given the importance of the control agreement, don't rely on assurances that it is a "standard form" that is not negotiated. Instead, take the time to tweak the two provisions discussed in this article. Those small revisions could make all the difference in protecting you as the lender. ■

Jacqueline A. Pueppke
Steven C. Turner

# Keeping Current: Best Practices for Garnishment of Bank Accounts to Collect Debts

Pundits sometimes jokingly refer to a garnishment subpoena mailed to a bank as a "valentine." A bank with a judgment of its own to collect can send such "valentines" to other banks. This article provides tips for use by a bank of deposit account garnishments to collect its own judgment debts. Although written for the judgment creditor bank, the article also will interest banks with setoff rights who receive garnishments of deposit accounts.

For convenience, this article uses definitions: The bank sending the garnishment – which has the judgment against its obligor—is called "Sending Bank." The bank receiving the garnishment is called "Garnished Bank." The judgment obligor is simply "Obligor." The article discusses bank accounts, but similar concepts apply to other financial institution accounts. This article omits discussion of determinations of whether an account contains federally-exempt deposits such as sometimes come from Social Security payments.

Bank account garnishment typically involves Sending Bank filing a pleading that generates a summons and standard garnishment interrogatories provided by the county court. Sending Bank often achieves better results if at the time it files its pleading it includes a request for special interrogatories to supplement the standard ones. Sending Bank attaches the special interrogatories to its pleading and then follows up with the county court or sheriff to ensure the special interrogatories become part of the summons packet issued by the county court. Special interrogatories provide much more thorough and useful information than standard interrogatories, such as:

- Date of closure of bank accounts, if applicable.
- Amount and payee or transferee of last checks or wire transfers or intrabank account transfers of closed accounts, if applicable.
- Description of allowed signers on a signature card for each pertinent bank account.
- Date and amount of last deposit(s) to each pertinent bank account.

Nebraska, Iowa, and many other states allow special interrogatories if related sufficiently to Obligor's rights (e.g., demand deposit accounts owned by Obligor) or other money or tangible property of Obligor possessed by Garnished Bank. *E.g., Tiefenthaler v. Citywide Ins., Inc.*, 2012 Neb. App. LEXIS 30 (Neb. Ct. App.). A counter tactic for Garnished Bank is to write into the special interrogatory responses a burdensomeness objection if providing the information would be costly or unduly time-consuming. Sending Bank is wise to anticipate such objections and to phone or write Garnished Bank shortly after Garnished Bank receives the garnishment packet. Sending Bank can offer to pay Garnished Bank's reasonable compliance costs or obtain an estimate of those costs if Garnished Bank insists on

reimbursement as a resolution of burden concerns.

Another issue involves Garnished Bank asserting a setoff. If Garnished Bank is owed debts by Obligor, Garnished Bank sometimes asserts no funds exist in the account because they have all been setoff. Specialized legal advice can help either bank avoid somewhat common mishandling of setoffs.

For example, Sending Bank should probe for documentation of the setoff and carefully compare when it occurred versus when Garnished Bank received the garnishment packet. If the garnishment packet arrived before Sending Bank documented any setoff in its records, Sending Bank often prevails in a subsequent court dispute with Garnished Bank (assuming setoff is the only right Garnished Bank asserts). The *Tiefenthaler* case illustrates this principle, although that case involved a garnished insurance company rather than a garnished bank. The insurance company had told Obligor's lawyer that "setoffs would be exercised." But the company did not successfully produce any documents that they in fact were exercised and, if so, *when*. The judgment creditor prevailed over the purported setoffs.

Sophisticated Garnished Banks may raise, instead of or in addition to setoff, alleged security interests in the pertinent bank account. Is Sending Bank thwarted from any recovery from the account? Not necessarily. Sending Bank should request documentation of the security interests. Even if the documentation is proper, Sending Bank has a limited time in which it may use a tactic sometimes called "forcing the issue." This involves contacting Garnished Bank to assert that Garnished Bank must either apply all funds in the bank account to pay down Garnished Bank's debt or acknowledge that Garnished Bank is in effect waiving its security interest by continuing to allow Obligor to use the account. Sending Bank then argues that such implied waiver elevates Sending Bank's garnishment lien to priority over the allegedly waived security interest.

Before deciding whether to "force the issue," Sending Bank should carefully attend to at least two legal points. One is the limited time Sending Bank has to object to Garnished Bank's answers to garnishment interrogatories. The limit is typically 20 days in Nebraska, for example. Second, some courts hold, in other involuntary debt collection contexts, that a creditor with a junior lien cannot lawfully sell collateral of a resisting creditor with a senior lien even though the junior lienholder agrees to sell it subject to any senior rights. Such courts might be sympathetic to Garnished Bank, although we are unaware of any court ruling against a Sending Bank recently for such a reason.

A last issue reminds Sending Bank to be sure to notify Obligor of the garnishment. A relatively recent federal decision in Iowa declared unconstitutional part of Iowa's garnishment statutes if applied to a bank account garnishment without due process notice to Obligor. *New v. Gemini Capital Group*, 859 F.Supp.2d 990 (S.D. Iowa 2012) involved somewhat unusual facts. The judgment creditor garnished Obligor's bank account but never asked the court to "condemn" the account and thus transfer the funds in it to the judgment creditor. As a result, Obligor claimed he never received timely notice of the garnishment and thus lacked due process. The *New* court agreed.

A Sending Bank presumably can avoid the New problem by always sending its own notice of garnishment to Obligor. However, as *New* recognizes, Sending Bank need not provide pre-garnishment notice to Obligor of intent to garnish: Pre-garnishment notice would allow too much opportunity for Obligor to deplete any bank accounts.

In conclusion, properly advised Garnished Banks can handle the garnishment packet "valentines" effectively to avoid a potentially bitter experience. Relatedly, Sending Banks can improve collection results if they follow effective legal tips in garnishing accounts at other banks. ■

Thomas O. Ashby

## FFIEC Issues Proposed Guidance on Social Media

On January 23, 2013, the Federal Financial Institutions Examinations Council ("FFIEC") issued "Social Media: Consumer Compliance Risk Management Guidance'' (the "Proposed Guidance"). Comments are due by March 25, 2013.

After consideration of public comments, the regulatory agencies that make up the FFIEC (the "Agencies") will issue final supervisory guidance to the

institutions that they supervise. Accordingly, such institutions will be expected to use the guidance in their efforts to ensure that their risk management practices adequately address social media risks.

The Agencies consider social media to be a form of interactive online communication in which users can generate and share content through text, images, audio, and/or video. Social media can take many forms, including micro-blogging sites (e.g., Facebook, Google Plus, MySpace, and Twitter); forums, blogs, customer review Web sites and bulletin boards (e.g., Yelp); photo and video sites (e.g., Flickr and YouTube); sites that enable professional networking (e.g., LinkedIn); virtual worlds (e.g., Second Life); and social games (e.g., FarmVille and CityVille). Social media can be distinguished from other online media in that the communication tends to be more interactive.

The Proposed Guidance notes that financial institutions may use social media in a variety of ways, including marketing, providing incentives, facilitating applications for new accounts, inviting feedback from the public, and engaging with existing and potential customers, for example, by receiving and responding to complaints, or providing loan pricing.

Use of social media by a financial institution to attract and interact with customers can impact a financial institution's risk profile. The increased risks can include the risk of harm to consumers, compliance and legal risk, operational risk, and reputation risk. Increased risk can arise from a variety of directions, including poor due diligence, oversight, or control on the part of the financial institution. The Proposed Guidance is meant to help financial institutions identify potential risk areas and to ensure institutions are aware of their responsibilities to oversee and control such risks within their overall risk management program.

**Compliance Risk Management Expectations for Social Media:**
A financial institution should have a risk management program that allows it to identify, measure, monitor, and control the risks related to social media. The size and complexity of the risk management program should be commensurate with the breadth of the financial institution's involvement in this medium. For instance, a financial institution that relies heavily on social media to attract and acquire new customers should have a more detailed program than one using social media only to a very limited extent. The risk management program should be designed with participation from specialists in compliance, technology, information security, legal, human resources, and marketing. A financial institution that has chosen not to use social media should still be prepared to address the potential for negative comments or complaints that may arise within the many social media platforms described above and provide guidance for employee use of social media.

Components of a risk management program should include:

- A governance structure with clear roles and responsibilities whereby the board of directors or senior management direct to financial institution's involvement in social media.

- Policies and procedures (either stand-alone or incorporated into other policies and procedures) regarding the use and monitoring of social media and compliance with all applicable consumer protection laws, regulations, and guidance. Further, policies and procedures should incorporate methodologies to address risks from online postings, edits, replies, and retention.

- A due diligence process for selecting and managing third- party service provider relationships in connection with social media.

- An employee training program that incorporates the institution's policies and procedures for official, work-related use of social media, and potentially for other uses of social media, including defining impermissible activities.

- An oversight process for monitoring information posted to proprietary social media sites administered by the financial institution or a contracted third party.

- Audit and compliance functions to ensure ongoing compliance with internal policies and all applicable laws, regulations, and guidance.

- Parameters for providing appropriate reporting to the financial institution's board of directors or senior management that enable

periodic evaluation of the effectiveness of the social media program and whether the program is achieving its stated objectives.

**Legal and Compliance Risks:** The Proposed Guidance details a number of federal laws and regulations which may impact a financial institution's use of social media.

**Reputation Risk:** The Proposed Guidance notes that a financial institution faces potential reputation risk arising from negative public opinion. Activities that result in dissatisfied consumers and/or negative publicity could harm the reputation and standing of the financial institution, even if the financial institution has not violated any law. Privacy and transparency issues, as well as other consumer protection concerns, arise in social media environments. Therefore, a financial institution engaged in social media activities must be sensitive to, and properly manage, the reputation risks that arise from those activities. Reputation risk can arise in areas including fraud and brand identity, third party relationships, privacy, consumer complaints and inquiries, and employee use of social media.

**Operational Risks:** Operational risk includes the risks posed by a financial institution's use of information technology (IT), which encompasses social media. The identification, monitoring, and management of IT-related risks are addressed in the FFIEC Information Technology Examination Handbook, as well as other supervisory guidance issued by the FFIEC or individual agencies. Depository institutions should pay particular attention to the booklets "Outsourcing Technology Services" and "Information Security" when using social media, and add social media to existing risk assessment and management programs. ■

Terrence P. Maher

## Upcoming Speaking Engagements

On March 22, 2013 Terrence P. Maher will speak at the American Conference Institute's 5th National Forum on Emerging Payment Systems in San Francisco, CA. Terry will be co-chairing the conference as well as presenting on a panel on "Developing, Implementing and Maintaining AML" and "Fraud Deterrence Strategies and Programs for Emerging Payment Systems." Terry will also present a workshop on "Credit, Debit and Prepaid Cards, New Regulations and Reforms and Their Impact on 'Traditional' Payment Methods."

Jesse D. Sitz and Jonathan J. Wegner will present at National Business Institute's Business Law Boot Camp. The seminar will take place on May 21, 2013 at the Scott Conference Center in Omaha. ■


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