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FINANCIAL SERVICES

Too BIG to Fail

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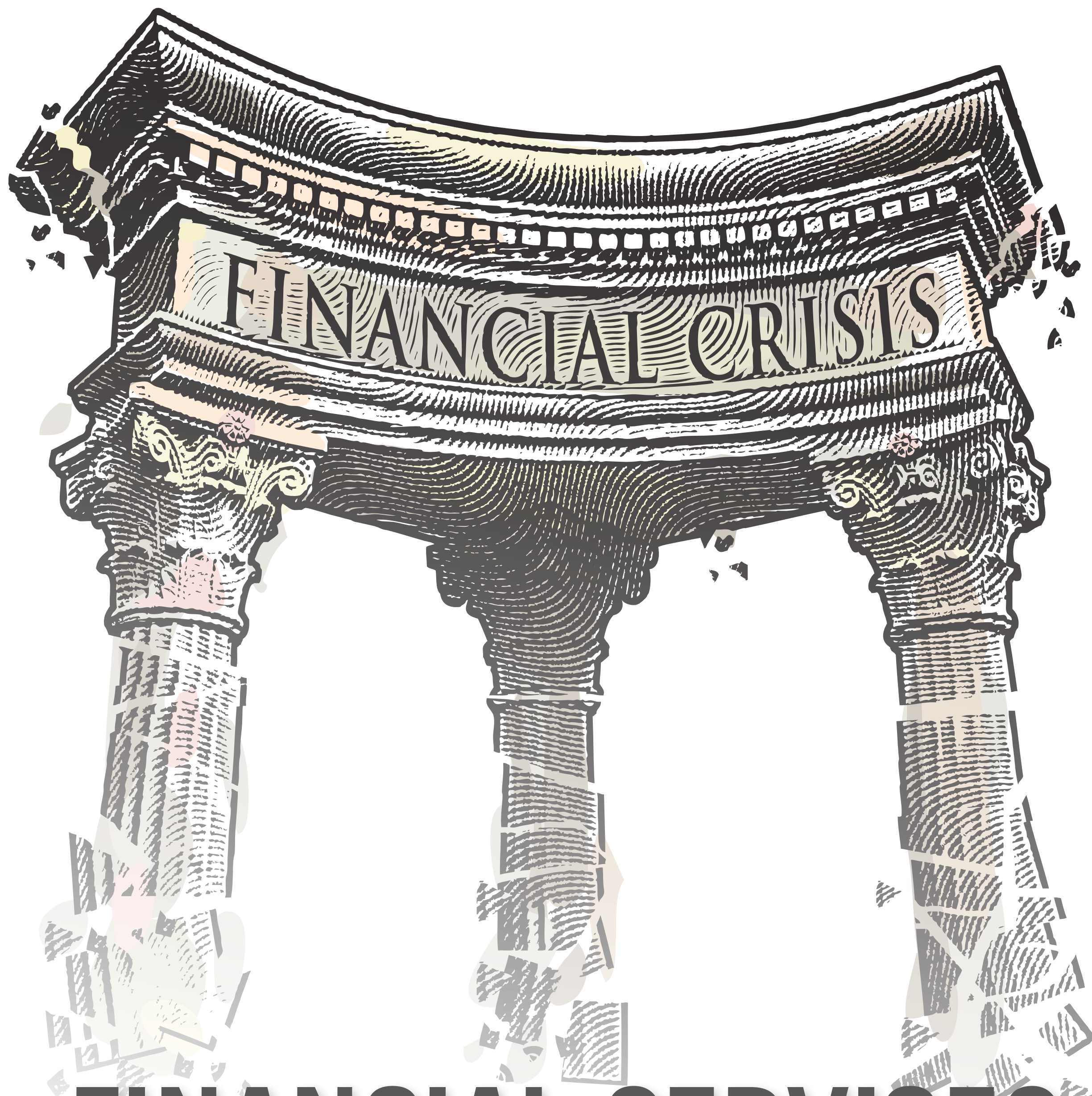

FINANCIAL SERVICES

Too BIG to Fail–What Now?

A Panel Discussion at the 2013 National Lawyers Convention

PANELISTS

Dr. Martin N. Baily, Bernard L. Schwartz Chair in
Economic Policy Development, Brookings Institution
Timothy P. Carney, Visiting Fellow, Culture of Competition Project,
American Enterprise Institute; and Senior Political Columnist, *Washington Examiner*
Randall D. Guynn, Partner and Head of the Financial Institutions Group,
Davis Polk & Wardwell LLP
Dr. Robert E. Litan, Director of Research, Bloomberg Government (at the time), subsequently,
Non-Resident Senior Fellow, Brookings Institution

MODERATOR

The Honorable Paul S. Atkins, Chief Executive Officer, Patomak Global Partners LLC; and
Former Commissioner, Securities and Exchange Commission

PAUL S. ATKINS: I welcome you to our panel today on Too Big to Fail. We have a lot to discuss here in about an hour and a half. My name is Paul Atkins, and it's a pleasure to be here today with you all, and I am joined by a very distinguished panel to discuss this issue, which is one that is at the forefront of the news these days.

Let me introduce our panelists. To my immediate right is Dr. Martin Baily. He is the former Chairman of the Council of Economic Advisors, serving from 1999 to 2001, and before that he was a member of the council from '94 to '96. He's been a Principal at McKinsey's Global Institute for many years and is an advisor to the Congressional Budget Office. He rejoined Brookings in September of 2007 to develop a program of research on business and the economy. He is studying growth innovation and how to speed our recovery. He is a senior advisor to the McKinsey Global Institute, senior director of Albright Stonebridge Group, and a member of the Squam Lake Group of Financial Economists.

Dr. Baily is the Co-Chair of the Bipartisan Policy Center Financial Reform Initiative, and is the Director of The Phoenix Companies of Hartford, Connecticut. He earned his Ph.D. from MIT and taught at Yale, Maryland, and MIT.

Tim Carney is a visiting fellow at AEI, and he helps direct the Culture of Competition Project, which examines barriers to competition in all areas of American life. He's a senior political columnist of the *Washington Examiner* and is the Eugene Pulliam Distinguished Visiting Professor of Journalism at Hillsdale College. He has worked on the Evans-Novak Political Report and was an editor with Regnery Publishing and also Human Events. He's the author of two books, *Obamanomics: How Barack Obama Is Bankrupting You and Enriching His Wall Street Friends, Corporate Lobbyists, and Union Bosses*, and second, *The Big Ripoff: How Big Business and Big Government Steal Your Money*. He has a bachelor's degree from St. John's College.

On my far right is Randy Guynn, who is a former colleague of mine. Randy is head of Davis Polk's Financial Institutions Group. He specializes in bank regulation and bank M&A, and he also played a role in drafting Title II, so he can talk from firsthand knowledge about his background. His clients include SIFMA, which is the Securities Industry and Financial Markets Association, and all six of the largest U.S. banks. Randy has a bachelor's degree from Brigham Young and his J.D. from University of Virginia, where he was Executive Editor of the Law Review.

And then, last but not least, is Dr. Robert Litan who is Director of Research at Bloomberg Finance. Bob was also previously Vice President and Director of Economic Studies at the Brookings Institution where he worked with us at AEI and especially with Peter Wallison, who is well known to you all here at the Federalist Society. He's also served in several capacities in the Federal Government during the Clinton years, including at the Office of Management and Budget as Associate Director and as Deputy Assistant Attorney General in charge of civil antitrust litigation and regulatory issues at the Department of Justice, where he also supervised the first Microsoft investigation, which resulted, of course, in the consent decree. Prior to joining Bloomberg, he was Vice Presidnet for Research at the Kauffman Foundation. Bob has his bachelor of science in economics from the Wharton School, his J.D. from Yale, and his M.Phil. and Ph.D. in economics from Yale as well.

So with that, I thought it might be useful to give you all just a little bit of background about where we are and how we got to Title II, because I think we have some folks who are very well versed in Dodd-Frank and in banking law, but we also have some folks who are just getting into the subject.

Just a few years ago, back in August of 2007, things started to get rocky, and there was a little known event that only became more significant as time went on. In 2007, BNP Paribas announced that it was suspending redemptions from three very small, really only institutional investment funds, but that was the harbinger of things to come in 2008. In March of '08, Bear Stearns failed, just about the same time that Eliot Spitzer got his comeuppance as Governor of New York. Then, in August and September of 2008, Fannie and Freddie failed. On September 15th, the opening of the floodgates occurred, when Merrill Lynch was rescued. Lehman filed for bankruptcy. The Reserve Primary Fund, which was a mutual fund mainly for institutional investors, halted its redemptions, and then, of course, the big event was AIG's failure. Washington Mutual failed after a slow-motion run.

The Treasury stepped in with a Temporary Guarantee Program that was more show than substance, but that helped create a false narrative of the causes of the crisis. The Federal Reserve in October swang into action with some commercial paper backstops, and then Congress passed the infamous TARP legislation, the Emergency Economic Stability Act of 2008, which started a whole alphabet soup of bailout programs. Many banks failed. In the 5 years prior to 2008, only 10 banks had failed, but from '08 to 2012, 465 banks failed. The largest bank failure in U.S. history was Washington Mutual in September of 2008, with JPMorgan picking up most of those assets.

After the financial crisis, the Deposit Insurance Fund slipped into the red by the end of September 2009, for the first time in its history. The FDIC then made up for that shortfall by requiring all banks and thrifts to prepay their assessments to the Bank Insurance Fund for 2010 in 2009.

In 2010, we had the Dodd-Frank Wall Street Reform and Consumer Protection Act passed by Congress, the same Congress that passed Obamacare. I like to say that whenever you hear "reform" and "consumer protection" in the same line, you had better watch your wallet. Dodd-Frank is 2,319 pages long

and has about 380,000-some words. Needless to say there is a lot left to be discovered within all of those words in Dodd-Frank. If you think about Sarbanes-Oxley, which was by comparison a very short statute, one of the provisions of Sarbanes-Oxley, the internal control requirement, Section 404, cost public companies billions of dollars to comply with, but there were only some 170 words in Sarbanes-Oxley 404. If you extrapolate that potentially to all of Dodd-Frank, you could have 2,000 such sections, and you can imagine if all of those have a similar unintended effect as 404 had, how much that would cost.

But suffice it to say that, whatever you might say about the Affordable Care Act, there is at least some philosophy that's guiding it. I compare the Affordable Care Act to a Jenga puzzle— if you start pulling out pieces, sooner or later it will topple over, and we might be seeing that happening right now. But by comparison, Dodd-Frank is a huge grab bag of "gimmes" that had been building up over years by several special interests, including the unions, trial lawyers, and others, and Dodd-Frank is not really interconnected. Certain parts of it are, but you could take a machine gun to it, and whatever is left will still pretty much operate on its own, given that these are all special giveaways.

It's not a very simple thing to just count on Dodd-Frank failing of its own weight. Of course, Governor Romney was campaigning to repeal Dodd-Frank. I'm not sure that would have happened, even had he gotten in, because there are special interests who like different parts of it—plus, once you tack on the "consumer protection" name, those sorts of attempts to repeal laws become difficult to get through Congress. But we'll see. There's a lot of time to go, and as Randy's firm has estimated, only about 40 percent of the mandated rules coming out of Dodd-Frank have been implemented.

So with that, I wanted to turn the discussion over to Randy to tell us some more on Title 2 and give you a briefing on that.

RANDALL D. GUYNN: Alright. One thing to get straight up front, I'm sort of for trying to solve the too-big-to-fail problem. I'm not really for any particular tool, whether it's Title 2 or the Bankruptcy Code. I'm for amending or shaping those tools, so that the problem is actually solved. I think before we can actually talk about what the current sort of best or what is more widely consider to the most viable solution right now, let me just try to put a little bit of context in what the too-big-to-fail problem is, how it arises, and the best way to think about it in the context of the bank failures.

As Paul said, there really were very few bank failures between the early 1990s and 2008, but in fact, that's sort of characteristic. If you look through history, you'll see that banks don't fail in a smooth way, the way nonfinancial institutions do. They tend to fail and vary in clumps, in waves. So if you look at the 19th century, tens or scores or even hundreds of banks would fail about every 9, 10, or 12 years during the 19th century. We had 10,000 banks then, relatively small banks fail during the Great Depression in the course of a year or two. During the S&L crisis in the late 1980s and the early '90s we had about 2,000 institutions fail. Then in 2008, as Paul mentioned, we had about 500 fail, although they were a lot larger than some of the banks before.

And this is interesting, because we're going to talk about the too-big-to-fail problem, and one of the solutions or potential solutions we're going to talk about on the panel is breaking them up. It's interesting, because in the 1930s, Carter Glass and others diagnosed the problem as being that the banks were too small and needed to be merged and bigger, so that they would be more diversified and not fail. I think they faced a problem with lots of small, undiversified banks. We now face a problem where they're large and diversified and they fail, so the diagnosis is they need to be broken up. And I guess my thought is I'm not sure either one of those is actually right. We are just kind of reacting to the situation that we face.

So the question is: Why do banks fail in waves, and why do we have a too-big-to-fail problem? And it really arises out of the nature of banks. Banks or other financial institutions engage in something called "maturity transformation," which means that they have demand deposits or other short-term liabilities that they fund themselves with, and then they transform that into longer term asset loans or other assets that they make to the public, maybe as long as 30 years, like a 30-year mortgage. When you have that mismatch between assets and liabilities, it means that if some common shock occurs, where the public becomes very nervous about the solvency or health of banks across the system, that fear becomes a self-fulfilling prophecy. Everybody says, "I better start withdrawing my money," and as you withdraw the money, the banks have to liquidate their assets. They can't liquidate them fast enough without the price of those assets falling, and so it tends to result in what is often referred to as contagion and a destabilization and possible collapse of the financial systems.

There has to be another choice besides bailout or risking a collapse of the financial system. I think that Title 2 of Dodd-Frank does provide the tools to actually address that problem and provide a third way.

When you have a destabilization or a collapse like that, there is a huge shrinkage in the supply of credit. I assume that there are probably lots of people who have taken a basic economics course, but if you take a basic economics course in macro, one of the things you learn about is a money multiplier, and it's the magic that $1 of deposit in a banking system can multiply into $10 of credit or $10 of money. When banks start failing, that multiplication is very aggressive in the other direction, so you have a very aggressive contraction of credit, and that then has consequences throughout the real economy, causing unemployment, lower output, and potential social unrest. When policymakers, whether they are committed to free market principle or whether they are beholding to Wall Street or whatever the flaw might be, is faced with a problem saying, "I have a choice. I can either take a bunch of taxpayer money and bail out the institutions or the only alternative I see is watching the financial system collapse," no matter how committed they are to doing the right thing during normal times, it appears—and almost probably is the case—that the lesser of two evils is to actually bail out the institution, at least if not the large institutions, maybe the whole system. The way TARP both gave capital to the large institutions but also spread it out throughout the whole banking system.

If you want to end the too-big-to-fail problem, in my view, what you have to do fundamentally, is find a third solution. There has to be another choice besides bailout or risking a collapse of the financial system. I think that Title 2 of Dodd-Frank does provide the tools to actually address that problem and provide a third way.

The criticism of Title 2 is that it's very open-ended. If

you look in Title 2, I am going to talk about a strategy for solving the problem that has come to be known as the single point of entry, recapitalization strategy or bail-in strategy, and then we're going to debate that and other alternatives. But the fact is you won't find that strategy written anywhere in Title 2 of Dodd-Frank. Title 2 of Dodd-Frank is a very broad grant of authority that basically says to the FDIC, "You have enough flexibility to do basically whatever the heck you want," and so that's the strength because it allows you to actually fit into a strategy like this. But it's also the weakness because no one has any idea whether the FDIC really will use it in that way or whether they might not use it in 10 or 15 other ways that we might find undesirable. The strength is flexibility. The weakness is lack of predictability, lack of due process and so forth.

The Bankruptcy Code is much better in terms of due process and predictability, but unfortunately, the way it's currently written, it is not very flexible dealing with these problems in a fast and efficient way. There are proposals to put in a new Chapter 14 of the Bankruptcy Code that would address some of these weaknesses, and I'm all for that. It would be much better if these problems could be solved using the Bankruptcy Code rather than Title 2 or at least reduce Title 2 to a very narrow scope.

I am now going to go through "single point of entry recap method." Our financial system is structured with holding companies at the top and operating companies down below as subsidiaries. If there are losses in a banking group, they're probably going to occur at the banks or at the brokerages or somewhere else. If an institution has cross-border operations, this creates a lot of problems in trying to solve it. If you actually had to put those operating companies into a receivership or a bankruptcy, it is going to be very difficult to maximize their value. It is going to be very difficult to do it on a cross-border basis.

So this method of single point of entry is a way to get around those problems by saying we are going to actually do all of the bankruptcy or receivership stuff at the holding company, and we're actually going to keep the operating subsidiaries alive through this process and operating and so forth.

Then how the single point of entry actually works, with a prerequisite. The holding companies, at least in this country, have a whole bunch of long-term debt, in addition to deposits at the bank, and when they raise long-term debt, they tend to raise it at the holding company level. In fact, there's equity at the holding company because of minimum capital requirements, but there is also this amount of long-term debt. How this method works is you have the legal tools, which you actually have in Title 2 of Dodd-Frank, and you probably have in the existing Bankruptcy Code, although nobody realized it 3 years ago, that you can actually convert this debt to equity.

The way you do it is to basically take all the assets of a failed bank holding company and transfer all those assets over to a "bridge financial company." Under Title 2, there is actually a mechanism to create a bridge financial company. The way you do it in the Bankruptcy Code is to have a shell company set up in advance, and you would transfer all those assets pursuant to Section 363 of the Bankruptcy Code. This could be done without credit or consent, because you're not transferring the assets away from the bankruptcy estate, you are putting them in a box to be held in trust for the benefit of the people that are left behind in the bankruptcy estate or in Title 2 behind a receivership. So what you leave behind are all the equity interests and all of the long-term debt claims, and by leaving those behind, you have now automatically recapitalized the business that's been transferred to this bridge financial company, because all it has is assets, and no liabilities. Let's just assume away short-term liabilities for a minute, but we can certainly talk about that.

Having done that, you now have a capitalized bridge with a whole bunch of assets, and one thing that you notice if you look at the balance sheets of the banks, at least in this country, is that a whole bunch of the assets on the unconsolidated balance

Hon. Paul S. Atkins

sheet of a bank holding company actually happens to be in the form of loans or advances or deposits to its affiliates, and those are actually wonderful assets for recapitalizing, because you can just forgive that intercompany loan. If you had a loan to a broker dealer that's undercapitalized, for example, by forgiving that loan, you have now actually recapitalized it. Or if the losses are in another subsidiary, you can actually contribute that receivable from the holding company down to the company that needs it and recapitalize it. So that's sort of how this works, and so step one is you transfer these assets over, and you recapitalize the holding company. Step two is how you actually downstream the assets to the operating companies and recapitalize them.

There is an intermediate step that's pretty critical. Now you have recapitalized the institution, but does the market trust it? And the answer is that the market will be nervous, because they really won't know whether it's sufficiently recapitalized or not, and so there is going to be a period of time, particularly if it's not an idiosyncratic in the private sector to actually provide liquidity even on a secured basis, which is where the so-called "orderly liquidation fund" comes in, in Title 2. That's where the Bankruptcy Code provides what's called "DIP financing," or debtor-in-possession financing, or you might actually need a government source of DIP financing to make the Bankruptcy Code actually viable for this. So you get liquidity, but it's not the same thing as providing capital. It's being provided on a secure basis, just like the Fed's discount window, so there's really no risk of loss.

Then over a period of time, you sort out who has what claims and what amounts in the company are left behind, and then step three comes in. You say, "Okay. During that period of time, we sorted out the claims." This new bridge financial company and the healthy or solvent operating companies are now healthy. We can wean them off the government-secured liquidity. They can get liquidity from the market. The liquidity sources will come back, as people calm down, and then when that has happened, you can then do an IPO, initial public offering of all the shares of that bridge company, and take the cash and distribute it to the claimants left behind in the bankruptcy estate or the receivership in accordance with the priority of their claim.

And if there is a risk of that, then we ought to amend the law to hardwire that, but that's what should happen, or you don't have to do an IPO. You could actually just distribute the shares

in the bridge company to the creditors that are left behind. And just like in a bankruptcy reorganization, the old creditors of the institution become the new owners of the new reorganized or, in this case, bridge company.

Then step four is that the receivership terminates. It's now a normal company again. Notice if you were to compare the balance sheets at the beginning to this, obviously these are sort of hypothetical numbers, but the balance sheet has basically shrunk in half, as this thing has been recapitalized and absorbed losses, and that's what you will see in these techniques. There will virtually always be some substantial shrinkage in the balance sheet from start to finish.

The single point of entry strategy has been tested. There have been simulations done by both government agencies and clearinghouses, sufficiently so that despite Paul's skepticism, it's actually really become pretty well accepted. The FDIC accepts it right away. Governor Tarullo of the Fed and Bill Dudley of the New York Fed recently said, "We think it works." We have the former Deputy Governor for Financial Stability of the Bank of England, who has probably given more speeches saying it will work in the U.S. and could work now than even the U.S. authorities have, and it's been sort of embraced in Germany and Switzerland. Increasingly, people think this is the way.

Now, the problem is, for the strategy to work, you have to make sure there is enough equity and long-term debt at the holding company level. If you don't have enough, it will not work, and so the Fed has been threatening to propose a regulation to have a minimum combined equity and long-term debt and eligible assets requirement at bank holding companies, and the Bank of England has actually threatened to force UK banks to reorganize themselves more along the lines of the U.S. bank holding companies. Actually, most of the UK banks are already organized withholding companies, but they tend to raise their long-term debt at the subsidiary bank level rather than the holding company, and there may be a push to move that long-term debt up to the holding company, because that's a way people increasingly believe that these institutions can be resolved if they fail in a way that does not require taxpayer money and will reduce the risk of the sort of destabilization or collapse that you fear in other alternatives.

PAUL S. ATKINS: So on that note, I'd like to turn to Tim Carney to give his views.

TIMOTHY P. CARNEY: Welcome, everyone. If you're from outside of D.C., you might be impressed by how well our economy is doing here, and for that, you can thank things like Obamacare and Dodd-Frank, which gives us all tons of work to do. You notice there's now a trade association for absolutely everything. I saw a lobbying filing for the National Cannabis Association, the Gulf Course Supervisors Association. There's even a future bank lobbyists of America. Of course, it doesn't go by that name. It goes by the House Financial Services Committee and the Senate Banking Committee.

The big banks are getting bigger, and this surprised Elizabeth Warren. She said, "Well, we have a law that's supposed to address this. Why is it happening?" Regulations act as barriers to entry, keeping out new entrants or keeping them small. And there is the continued perception of a bailout. The funding advantage, as described by economists at the IMF, is 80 basis points, almost a full percentage point lower on the borrowing cost of a too-big-to-fail bank, than it would be without the perception of a bailout.

I have a colleague at AEI, Abby McCloskey, who says it's not nearly that high, but it is 20 basis points. So, yes, a big bank gets an advantage from the perception that the creditors will be bailed out, and they borrow at less. This ought to upset us if you're a free market person, because government intervention—in this case, implicit government intervention—is distorting the market in favor of the big guys.

The four or five biggest banks are 30 percent bigger than they were before the crisis.

There was a recent study that said if you use European methods of accounting, JPMorgan plus Bank of America plus Citigroup would have combined assets of $14.7 trillion, approximately 93 percent of the whole U.S. economy.

So these guys are getting bigger, and part of the reason they are getting bigger, a lot of people argue, is not economies of scale in the way that Walmart gets better prices through its economies of scale, but political economies of scale: the perception that they will be bailed out and, thus, the ability to borrow far cheaper than their competitors and cheaper than they would be in a non-bailout market.

Does Dodd-Frank address that? On paper, it does. But think about what will happen when we do have a financial crisis. Think about what will happen when multiple banks are to fail.

There was quite a bit of cooperation between Democrats and Republicans moving towards a financial reform, and I think, ideally, that could have gone through. A bipartisan Dodd-Frank would have been a better bill.

Do you think that you won't have Treasury Secretary Romney or Treasury Secretary Schumer saying, "Well, you know, those laws were passed for a certain circumstance, but right now we can't let this happen"? The long-term creditors are supposed to lose a lot of their money. A lot of those long-term creditors are going to be themselves very systemically important financial institutions. Oh, it's all right to let them have a haircut, but when the people taking the haircut are other SIFIs, are we really going to let them fail?

The letter of the law is that we're not going to have bailouts. Fannie Mae and Freddie Mac: How many times did we get assured that they weren't going to be bailed out? Constantly. Barney Frank, whose name is in Dodd-Frank—said it was a figment of our imagination that there was an implicit bailout of Fannie and Freddie until the bailout happened, and it doesn't just take a President to do this. Congress could just change the law. TARP did not exist before the fall of 2008. When we actually enter into a financial crisis, do you think that our political class will have the guts to stand by this and do something unprecedented and try not to bail these guys out, to try and do an orderly liquidation in a very disorderly environment?

I think that the answer is no, not just because our politicians will be afraid, but also because of the way that special interests work in this town. There will be enough people who will be tied to the big banks, tied to the other important financial institutions, who will go ahead and will have the ear of the chairmen of the committees, will have the ear of Treasury, will have the ear of the White House, and will say, "No. You simply can't let this happen. You simply can't let us take a haircut. You simply can't let our long-term creditors take that large of a haircut." That's when the rubber meets the road, when we're actually in that

crisis, I don't see these rules standing up to the panic. If there's one bank failure, maybe that will work, but that's not really what this is written for, right? This is written for a systemic crisis, and it's exactly in that situation where the panic, the special interest influence in Washington will undermine it.

PAUL S. ATKINS: Thank you. Martin, would you like to add anything?

MARTIN N. BAILY: We did have a financial crisis, and there was general agreement both in Congress and among the American people that something needed to be done to try to make the system safer. There was quite a bit of cooperation between Democrats and Republicans moving towards a financial reform bill, and ideally, that could have gone through. A bipartisan Dodd-Frank would have been a better bill. For various reasons, that didn't happen. The Republicans withdrew. The Democrats didn't want certain things that the Republicans wanted, and so we ended up with the bill we've got.

At the Bipartisan Policy Center, our view is that we support Dodd-Frank, but that there are provisions that (a) have not yet been implemented, so there's quite a bit of work to be done around the implementation; and (b) there are some things that maybe need to be changed to make sure that we have an efficient financial system that encourages growth as well as being safer than the one that we had.

The contributions made by the FDIC and by my colleagues at the Bipartisan Policy Center, notably Randy Guynn, to deal with the too-big-to-fail problem have really made a tremendous contribution. This is a huge breakthrough.

If you think about our economy, there are many large corporations that, if they were to completely collapse tomorrow, would create a lot of disruption. If, for example, any one of the major airlines, one of the big utilities, the phone company, the drug companies – if they were to collapse and cease operations, that would be very disruptive.

A number of the airlines have been through bankruptcy and have continued to fly and continued to operate. What was needed with banks was to find a way to continue their operations despite failure, because if their operations were to shut down, both if the retail banks were to close but also if the wholesale activities were to suddenly shut down, it would be very disruptive. If more than one large bank that was in trouble, then the economy would be threatened with going back to the Great Depression.

And by the way, I'd like to say the steps that were taken by Paulson, by Geithner and Bernanke, they were necessary at the time in order to avoid a more severe recession than the one we've had, while they have created some legacy of moral hazard.

Let's talk about the too-big-to-fail plan that's in place. The thing that it does that's essential is that it puts the burden or cost of the collapse of an institution on the equity holders and the long-term unsecured debt holders, and you can do that because those folks cannot run. The equity holders obviously are the owners. They can only sell if they find someone else to sell to. The long-term debt holders cannot run, because the debt is long term. So the costs will fall onto those people, and that's now been mandated in Dodd-Frank and is very much a part of what the FDIC is putting in place. They're saying that the equity and long term debt holders will bear the cost of failure.

Going through the process of reorganizing a JPMorgan or a Citi is a very complex process. It can be done now either through bankruptcy or through Title 2, but the key thing is that you get rid of the moral hazard by making sure the costs fall on the equity holders and the long-term debt holders.

One important result of the new failure resolution plan is that whatever there may have been in the way of funding subsidy for large banks in the past is now disappearing for the large banks in the United States, and we know that in part because Moody's just issued today or yesterday a statement saying that they were removing any premium that they had on the debt of the large bank holding companies, because they recognized that those financial assets were going to have to take losses in the event that the bank failed. It is now getting through to the markets and it's getting through to the rating companies that we no longer have that ratings advantage for too-big-to-fai banks.

There was a statement earlier about how banks are getting bigger. One comment on this is that the banks were pushed into forced mergers, so we're in a funny kind of situation where now the government has said, "Oh, you have to merge. You have to become bigger," but now we're turning around and saying, "Well, you're too big. Now we have to break you up."

I am concerned about some of the very small banks, the less-than-$2-billion banks. They are going to find it very difficult to operate under the regulatory burden that's currently in Dodd-Frank. What we need to do is resist pressures from the far left or the far right, watch your wallet when those two groups are combining, and make sure that we create a level playing field, so that the larger banks can compete and the smaller banks can as well, so that we can let the market really decide what size banks should be. If we do that, you will continue to see large banks.

The Business Roundtable recently released a report saying that their members, the large corporations, find it essential to work with large banks, either in their domestic operations or in their foreign operations. We would be shooting our economy in the foot and shooting our competitiveness in the foot to try to break up the large banks. That's not something we need to do or something we should do.

Robert E. Litan and Timothy P. Carney

There was a point made earlier, which needs to be addressed. We don't want the long-term unsecured debt of the big banks to be held by other big banks. Obviously, that would be a ridiculous arrangement. We want to make sure that that long-term unsecured debt, which is going to take a hit, is held outside of the financial sector or outside of the financial sector that's subject to this kind of threat of collapse.

It's important to bear in mind that the key at the end of the day is to make sure we have an economy that works, that we have the funds for economy growth to fund investment. Our investment level is relatively low. It needs to go back up to create the jobs and get the economic growth that we're looking for. So let's take advantage of what I think has been a breakthrough by the FDIC and by folks like Randy to try to find a way through that allow us to have large banks, have the advantages of those

large banks, but let the cost of potential bankruptcy or failure fall on the people who should bear that cost.

PAUL S. ATKINS: Thank you. Bob?

ROBERT E. LITAN: Let me try to make a couple of distinctions and then try to address the issue of what I think we ought to do about the too-big-to-fail problem.

So the first distinction has already been referred to, and that is between bank depositors, on the one hand, equity and long-term debt holders, on the other. When we talk about too-big-to-fail, let's be 100 percent clear—that in the case of the financial crisis, the institutions that took TARP, and so forth, their shareholders got wiped out. So really what we're talking about when we're talking about "too big to fail" are the non-deposit debt holders, and they did get bailed out.

The second distinction refers to large "nonbanks" or bank holding companies, which are subject to Title 2 of Dodd-Frank. These are institutions Randy was talking about. They include large bank holding companies, AIG, Prudential, or GE Capital. Title's resolution authority was aimed at reducing taxpayer bailout risks for all these institutions by setting up an "orderly liquidation" procedure for winding them down if they run into severe financial trouble.

A separate part of the legal landscape that is relevant to this discussion is the Federal Deposit Insurance Improvement Act of 1991. FDICIA was enacted after the last real banking crisis, and addressed at banks, not holding companies. FDICIA has a section that says depositors will take a hit if they are not insured unless there are systemic consequences. If a bank is going to fail, there is what's called a "systemic risk exception," and that's been in the law now for 22 years. So I want to get to banks, because that systemic risk exception is what creates too-big-to-fail, and what we ought as a policy matter try to address is how to keep to a minimum the probability that the systemic resk exception will be invoked.

Let me go back to Title 2 of Dodd-Frank. Randy was essentially arguing that the best way to solve the too-big-to-fail problem for non-banks and for large financial institutions is cut off the head of the snake. The single point of entry basically is the head, or the holding company. It's got shareholders, and it has long-term debt holders. Make sure each takes a loss in the event part or all of the financial institution gets into trouble. That's what his proposal, building on the framework established by Title 2 of Dodd-Frank, is designed to do.

My first reaction is to give this idea a try and see if it works. A lot of people think it will, while others are more skeptical. We must wait for the next financial crisis to find out if shareholders and debt holders of troubled holding companies will be haircut, and if so, whether this will not trigger a wider financial panic.

If regulators blink and bail out these investors when the time comes, there will be pressure, I predict, to move toward a special bankruptcy court, Chapter 14, for troubled non-banks. The one reason why a lot of people are skeptical the resolution process established by Title 2 won't work is not just the open-endedness that Randy talked about, but the presence of provision for "liquidity assistance." By this I mean, the ability the Treasury and the FDIC have under Dodd-Frank to borrow money if they feel that there is a systemic risk involved, and they can give the money to this institution that's in trouble. Then basically, the law says that the people who benefit from it are somehow supposed to pay it back, and if they don't pay it back, the Treasury will assess all other large non-bank financial institutions, and then they'll pay the Treasury back.

Now, the good part about all this is at least taxpayers don't get hit. The bad part is that you still have moral hazard, because there's another group of people who are going to pay for losses. But I'd say putting that aside—and that is a non-trivial risk—I still take the view that we should be willing to see if regulators have the guts to actually go ahead and go through with the haircuts the way the new law envisions. Randy's scheme maximizes the probability that they will, because the single point of entry is designed to assure that the people underneath can still operate.

Now let me return to the issue of failing banks and the systemic risk exception. When you invoke the systemic risk exception, it means all the uninsured depositors are protected against loss. Take Citigroup or JPMorgan or any of the other big banks. Most of their deposits are technically uninsured, and so it's in the law that nonetheless the holders of these deposits can be protected 100 cents on the dollar, if their bank fails. That's moral hazard. That's too-big-to-fail.

So what can policy do to keep the probability of these too-big-to-fail scenarios to a minimum? I see three options. Number one, you can break up the big banks. Number two, you require these banks to have a lot of capital. Or number three, the authorities can much more clearly indicate that at least some creditors will not be bailed out without entailing systemic risk. Let me take these in order.

Randall D. Guynn

Martin has already addressed some of the problems with breaking up the banks. I'm going to add some more. One reason is that if the U.S. broke up its large banks and other countries did not, we might be disadvantaging our financial industry and potentially some of its customers in the global marketplace. A second problem arises from the prospect of having 20 medium sized banks, each with $100-200 billion in assets, instead of five very large ones. In that world, what makes one think that a run on one or two of the twenty might not trigger runs on the others. Policy makers certainly would have that fear, and if they then bailed out all uninsured depositors at all of the twenty, what will have been gained from the breakup?

The final point I'll make about the breakup option is that I get very nervous when people confidently say they know at what size economies of scale are exhausted. The authors of the Brown-Vitter bill, for example, implicitly claim that the line is at $500 billion in assets. But do they or anyone else really know that for sure? Do you trust the Congress to pick the right number? I don't, and by the way, even if by some magic they pick the right number today, is it going to be the right number tomorrow or in 10 years or in 15 years, or if we index it to inflation? You get my drift. I just do not believe there is any principled way of picking a particular asset size,

and then saying, you can't be bigger than that.

What higher capital standards, the second option? Well, if you watched Janet Yellen yesterday and her testimony, she was asked about too-big-to-fail, and her answer basically was that we've raised capital standards since the financial crisis, and we're doing a good job, and too-big-to-fail is less likely in the banks. She's right.

I would only add that policy makers should raise capital standards a little more than what they're already planning to do. Tim points out the studies showing that the large banks have a funding advantage of 20 to 80 basis points. Bloomberg Government went through a simulation exercise, and we asked ourselves how much additional capital would be required among the top banks to offset this funding advantage. We estimated that if all the big banks were required to have an additional 2 percentage points of risk-based capital, it would solve the problem, and would eliminate the funding advantage. So it doesn't get you to 15 percent capital on an un-weighted basis. Two percentage extra points on the risk-adjusted measure maybe takes you from 6 percent to 8 percent on an un-weighted basis.

If you're not happy with that and you want more capital, then I have an answer for you. I'm a big fan of what's called "contingent capital." The idea behind contingent capital is that banks be required to issue a certain amount of unsecured long-term debt that automatically converts into equity upon some well-defined bank-like regulatory intervention or if the market value of the bank (if publicly owned) falls below a certain threshold. So if you are worried about the long-term bondholders getting bailed out, the simple thing with contingent capital is they get bailed in. They get their debt and convert it into equity. They are put at risk.

By the way, that's what happens in a lot of bankruptcy proceedings. The debt of the bankrupt company gets converted to equity. So if you are really worried that 8 percent is not enough, add another couple points of contingent capital, and that should be enough. To be sure there is a bailout risk even with contigent capital. But I think that risk is dramatically lower than what we have now.

One thing I think the FDIC should do that it has not done is just issue a statement that simply says, henceforth, "we are not going to protect unsecured long-term debt holders." There will still be the systemic risk exception, which we hope regulators won't have to invoke, but they could very clearly state that, "If you're not a depositor and you're a creditor of a bank, you're at risk. We're not going to pay you off." And Tim may say that's not a credible promise, but I would say that as long as you've got the other things in place—hard capital, contingent capital, and so forth—the chances that they'll ever be called on this are substantially reduced from what they are now. So I think it's worth having that statement on the record that people aren't going to get bailed out.

My final point, the rating agency yesterday, Moody's—and I predict S&P is going to follow—has already downgraded the debt of the large bank holding companies, because it believes, even without this FDIC statement, that the probability of a bailout is a lot lower than what it used to be. The market is working. The market is saying, hey, these guys are probably at risk.

So the bottom line is too-big-to-fail is a real problem. We're moving to address it. We could probably do a little more.

TIMOTHY P. CARNEY: I agree with Bob in not trusting our political process to pick the right level, that's a good instinct, but sometimes the alternative is trusting our regulators to be very smart. When people talk about smart regulations, they say, "Well, we need to weigh this sort of capital this way and classify this, this way," and a lot of times, I think maybe what we need instead of smart regulations are dumb regulations; in other words, blunt hard rules.

That is the only way, especially in the instance of a panic and a crisis, to prevent the banks from seeing this set of regulations as a roadmap to doing whatever they want to do. That was always what the Enron guy said: The more complicated the rules, the more fun it was for them to figure out how to get from where they are to what they want to do, regardless of the rules, whether the rules said not to do it. You create these complicated rules about who is allowed to hold your long-term credit and they'll use a holding company through some other operation.

One thing I think the FDIC should do that it has not done, I think it should just issue a statement that simply says, henceforth, "we are not going to protect unsecured long-term debt holders."

So if you have a role that says, all right, maybe the only way to prevent these guys from getting bailed out is to say you lose your access to FDIC or Fed lending window above a certain level. Yeah, that's going to be a little bit arbitrary, but maybe arbitrary and clear-cut is better than sort of complex, precise, and infinitely game-able.

Just a last update on Moody's. It is true, when I saw the Moody's Credit Report come out this morning when I woke up, I was really hoping that it wasn't going to say what it ended up saying, because frankly, if this is true, if the creditors for the holding companies won't get any government support. If the market starts to reflect that, if the funding advantage disappears, then that does take away a lot of the argument, that does indicate that what these guys are doing is working. But I would wait till the market shows—until the credit market shows that and not just trust Moody's and S&P, because trusting Moody's and S&P has gotten us in trouble before.

MARTIN N. BAILY: But it is showing it. The market is showing that the interest rates that these banks are paying have moved up.

TIMOTHY P. CARNEY: Yes.

MARTIN N. BAILY: So the markets are responding.

TIMOTHY P. CARNEY: That's exactly right. But until the markets show that there isn't a funding advantage, we still know that we have government-subsidized big banks, and the subsidy is based on the assumption by creditors that there is going to be a bailout. And that assumption itself ends up being self-fulfilling. So if we get that subsidy, that funding advantage down to zero, and if the people lending money to the banks are operating as if they're not going to get bailed out, that itself would be a big advantage. Until that's the point, I think we have to worry about the fact that these guys' size is itself a reason to invest in it, not because of economies of scale entirely, but in part because of political advantage.

PAUL S. ATKINS: We have a microphone in the back, and so I invite you all, if you have questions, to please step up, and we will work you into the conversation here. I want to call on our first questioner.

JOHN MCGINNIS: I'm John McGinnis. I'm a constitutional law professor, and so I come from this very far away. I just want to ask sort of a conceptual question, I guess, to Randall Guynn. Is this the second-best solution? Given that we're going to have incentives to—or the government will bail people out, would a better situation be a constitutional amendment saying no bailouts, no deposit insurance?

I ask that question to try to give this conceptual issue, which is: if your idea is so great, presumably people are worried about contagion, people would invest, and we'd see if that's the way to do it. But one of the advantages is the market comes up with all sorts of solutions that I'm not confident regulators or even any individual can figure out.

So my question is wouldn't that be—maybe we can't get there, but a better solution than yours is a solution only in this very second-best world.

RANDALL D. GUYNN: Well, I'm actually skeptical about the effectiveness of mandates, whether they are in a statute or even a Constitution. I think at the founding of this country, there was a belief that we had an Enumerated Powers Doctrine that the Federal Government only had those powers that were enumerated in the Constitution. We have seen that those who were skeptical of that turned out to be more prescient than those who defended it. And we saw that even as early as the first presidency when there was a big debate about whether Congress had power to set up the First Bank of the United States. Jefferson wrote an opinion as the Attorney General, or maybe the Secretary of State. I can't remember which, but there were two opinions saying this was unconstitutional, and then Hamilton made his argument, and George Washington signed that bill.

So I guess I'm a little bit skeptical of that, because when the public and leaders see a real dilemma and a policy problem where people are going to lose a lot of money, where they're going to lose just a lot of real problems in the economy, they will come up with creative ways to get around that problem.

That is why I think the only real viable solution is not a mandate. It's not even everybody getting together and having pledges to each other to pledge their allegiance to the free market. Instead, it's to actually have a viable solution that will actually work in the real world and will eliminate these incentives, which I think do exist, to bail out institutions. And that's the real key is finding something that works practically, so that the incentives of the policymakers line up with not bailing out institutions.

MARTIN N. BAILY: I would just add that financial instability and the collapse of banks is something that well pre-dates deposit insurance of many of these other provisions. I am a big believer in free markets, but there is a tendency of such markets to be unstable at times, and we need the institutions to make sure that that instability is limited.

BERT ELY: Bert Ely, a banking consultant and member of the Financial Services Executive Committee.

A question for Tim that others might want to jump in on. You repeated the assertion that's been made by many that the so-called "too-big-to-fail banks" are getting this huge subsidy, by virtue of their size, and supposedly to be bailed out. I've looked at this question closely, and I've asked this question, for which I haven't been able to get an answer. If the big banks are getting this huge subsidy, who ultimately benefits from it? Is it the shareholders of these big banks? Is it the executives or somebody else? Put it another way, if you can't identify who the ultimate beneficiaries of the subsidy are, is in fact there really a too-big-to-fail or too-big bank subsidy?

If I could make another point with regard to contingent capital, I think Bob talked about, how does contingent capital differ from convertible preferred or convertible debt? Isn't that essentially the same thing, except that you have an additional basis on which a conversion would take place?

ROBERT E. LITAN: I'll just very quickly answer that. Yes, it is convertible, except there is a provision in it that basically says the conversion happens automatically whether regulatory intervention or upon some determination, the capital isn't there or something like that. But you're right, it's a convertible security.

BERT ELY: I'm interested in Tim's answer on the subsidy question. Who gets it?

TIMOTHY P. CARNEY: I would think that if you start by thinking about the institution before we get down to the individuals; the institution's ability to get capital at lower cost than smaller competitors ends up tilting—sending more capital to the too-big-to-fail ones than would go there without the subsidy. Assuming that banks are good at turning capital into profits, the shareholders of those big guys are going to make a profit. But also, I just think you can call it a subsidy without pointing to specific beneficiaries just because, again, you know that they are going to get a bigger slice of the economy than they would without this presumption that they are going to get bailed out.

PAUL S. ATKINS: Well, one thing just to throw in: The shareholders and others—customers of the banks—get it, but of course, any subsidy is a distortion of the marketplace, and so consumers overall and taxpayers ultimately pay.

NICK CHIDIAC: Nick Chidiac. I'm President of the George Washington Chapter.

Talking about risk-weighted capital, in terms of these different rules, you have a sense of creating some uniformity through the system, which then means that our failures end up being all the banks sort of fail in the same way. How can we, in building these regulatory structures, prevent ourselves from falling into that trap where even if we get a little more time before the next crisis ends up being more cataclysmic because all the banks are, because of the regulatory structures, failing in exactly the same way at the same time?

RANDALL D. GUYNN: That's a really good question, I just want to say, and I'm not sure there is a really good answer to it.

But the fact is as long as we find maturity transformation to actually be a social good, which I think people have come to believe that it is, where all of us can make—we have very good liquid sources of making our payments and we also have sources to get long-term credit, there is always going to be a certain correlation in the failures of waves of banks. And the only way that we can try to reduce that is to have the right level of capital.

I think Bob is right that there may be a case for having—well, certainly, there's a case for having more than what existed during the financial—or preceding the financial crisis. I am also with him, I think that the Brown-Vitter level of 15 percent leverage is excessive, and we would pay for it in terms of having less credit available. I think he raised a good point that if we have rules, they will tend to encourage people to invest in the same ways, and if the

banks or even the shadow banks sort of have very similar assets on their balance sheets, if there is a common shot that affects the value of one, it's going to affect the value at least in a certain way of everybody to the extent they mimic. So you'd like to see a lot more diversity and less mimicry among the financial institutions, but I think their behavior—the reason it's a hard problem is it's so much—anybody that's competing in the economy tends to look over who they think is their good competitor and say, "They must be making money. I better do the same thing and make money the same way," and so there is sort of a bias in favor of mimicry, which creates these correlations of failures.

TIMOTHY P. CARNEY: I just want to quickly add on sort of reserve requirements, just in case anybody out there is libertarian, worried about capital requirements, reserve requirements, why are we placing these rules on the banks?

There's a point at which the laissez-faire arguments just don't apply, and when the taxpayers are the insurer of the banks, which we are in multiple ways, including implicit bailouts, then we absolutely have the right—the government absolutely has the right to set these sort of standards. Say just like the insurer of your company can set up standards on how much risk you take in your company, and the question of figuring out where to put that level is obviously incredibly difficult.

MARTIN N. BAILY: Can I just comment on your point? Your point is that institutions tend to do the same thing, and I think that's a reason—and Bob alluded to it—why just breaking up the banks won't necessarily help you, because if you break a large bank into 20 smaller banks, they may end up all buying bad real estate assets, just as big, medium-sized, and small banks in the last crisis all bought a lot of bad real estate assets.

Dodd-Frank tried to address the point you raise by creating the FSOC, the Financial Stability Oversight Council, and the Office of Financial Research to provide more data. I think transparency is important, that we should have access to data when we have the crisis. The Federal Reserve, in many cases, didn't know what was going on inside a lot of these institutions. Now I think we would have greater information.

I wish I could say I'm more enthusiastic. I wish I would be more enthusiastic about how the FSOC and the OFR are working at the moment. I'm not so enthusiastic, but that was the effort that was made in Dodd-Frank.

PAUL S. ATKINS: I think just one more point to your question: When you look at the stress testing— and how the Fed and other bank regulators are basically forcing all the banks to go down the same road and put them in the same type of risk-management mode—I think your question about the lemming-like result is really troubling, when we look at facing the next economic crisis. I don't have any real confidence that the regulators are going to be able to see above the hills to the future.

ANDY RADLEY: Yes. Andy Radley from Minneapolis, Minnesota.

It seems to me the issue is not shareholders and long-term debt holders at the holding company level, but the counterparties. We sort of decided to prevent runs on banks. We instituted deposit insurance, and it's more or less worked in allowing for some intermediate maturity, whatever you called it, turning short-term assets into long-term assets. The too-big-to-fail financial institutions are not financed primarily or in large part through them, in addition to depositors, counterparties, some of who are explicitly sort of making credit transactions, but others of whom are just doing business. And the question is what protection you give counterparties, and if you don't give protection to counterparties, there will still be runs on banks and all the issues? So it seems to me the real issue is what you do with counterparties?

RANDALL D. GUYNN: Counterparties are supposed to monitor the system.

ANDY RADLEY: As were depositors way back when, but is that realistic, do you believe, or should there be a variety of transactions that people can do without having to be sort of credit analysts?

RANDALL D. GUYNN: I think that's where the distinction between long-term and short-term credit comes in. I think it's the reason we have deposit insurance and it's justified to the extent it does what it does, and essentially, people sort of accept it as though deposit insurance doesn't create moral hazard, this other stuff does.

One of the criticisms of deposit insurance in the 1930s was it was going to create moral hazard, and it probably does create moral hazard, but we've decided that the amount of the benefits that we get from it offset the moral hazard that it creates.

But in fact, one of the criticisms of deposit insurance in the 1930s was it was going to create moral hazard, and it probably does create moral hazard, but we've decided that the amount of the benefits that we get from it offset the moral hazard that it creates. And the reason we sort of tolerate deposit insurance and counterparty protection with short-term credit is there's really nothing we can do about it. When there is a bank panic—and we saw this throughout the 19th century, we see it now—we really are kind of stuck. We've got to figure out a way not to have losses be borne by the short-term creditors, not because they deserve to be protected in any way but because they can run. And so if they can run, we've got a big problem we've got to solve, and so we end up findings ways, deposit insurance and others, to sort of reduce their incentives to run, because run means the system melts down.

In contrast, if we have counterparties that are actually shareholders and long-term credits, they can't run, and so I think the problem that we've had so far is we haven't made it crystal clear that in fact we're going to allocate the losses, because we can, to that portion of the private sector investors who can't run. Those happen to be the shareholders and the long-term creditors, and that's actually what we're making very explicit or trying to make explicit in things like the single point of entry or other sort of solutions here is instead of saying we're going to decide at the last minute, "Oh, my goodness, we're going to save the short-term creditors, and we're going to put the losses on long term," we're going to say in advance, because that way the market can actually price it. That means that, quite rightly so, people will be paying more for long-term debt, and people would be getting more return, so that it matches with the risk that they're taking. And it may actually be the short-term debt will cost less and short-term creditors will pay less and they'll get compensated less because they have bargained for the right to run, so to speak, and the

others have not. Essentially, it's a premium for the right to run and/or the reality that you can run or something.

I think the key here is to make it crystal clear what the rules are in advance and sort of adjust either by structural subordination or legal subordination to make it clear who is bearing those risks and who is not, and then the market hopefully will price that in and will price out any kind of subsidy.

J.W. VERRET: J.W. Verret. I'm the Chief Economist at House Financial Services on leave from George Mason.

So I want to push back on the observation that long-term unsecured debt is an effective subspecies of contingent capital, and particularly, I find very intellectually interesting, the Calomiris proposal for market-triggered contingent capital. It seems to me that method is far superior to the contingent nature of long-term unsecured debt and even superior to the contingent capital approach that the Swiss have taken that uses regulatory accounting-based capital, which is quite a lag. But it seems to me the Calomiris proposal is the optimal sort of approach to use a contingent capital notion, particularly just because it comes into play so much earlier in a time period of unhealthy for a bank. It's like going to the doctor on the first day you have a cold rather than the seventh day that you have a cold and sort of calling his bluff on whether he's going to give you extra medicine or something like that. So it seems to me, there's a lot to be said for that notion, but regrettably, it seems that the Fed has, despite OFR's studies on contingent capital that were initially very positive and some statements from Yellen that I think were very positive on the notion of contingent capital, Tarullo seems to have dismissed that sort of out of hand. And so that notion has sort of been dropped, and it seems to me that one way to do it would be in the long-term unsecured debt requirement, permit some banks to issue this market-triggered contingent capital, others—you know, as a way to signal that we have faith in our stockholders and in the strength of our stock price, and others maybe wouldn't. And it seems to me, that would be a great sort of signaling approach, and regrettably, I anticipate it probably won't be part of the long-term unsecured debt discussion.

But I wonder if folks have general observation about the Calomiris proposal and finding some sort of path for it, because I know there's a tax deductibility obstacle, obviously, which begs for a solution, I think. But it seems to be a very interesting idea, and I would be interested to hear anyone's comment.

ROBERT E. LITAN: Okay. So I know this proposal very well, because I had talked to Charlie about it when he was writing about it. Just to be correct, he wrote it with Dick Herring also.

J.W. VERRET: Right, absolutely.

ROBERT E. LITAN: So I think it should be called the "Calomiris-Herring proposal." And for those of you who don't know what this is, I mean, I didn't get into the weeds when I talked about the contingent capital, but there are two ways you can trigger this. One is you can trigger it upon some regulatory intervention, and the problem with that is that the regulators are too late. So that's a problem.

So what Charlie and Dick have said is what they're going to do is look at a 90-day moving average, I believe, if I recall this right, of essentially the spread, I think, of what they're paying on the debt versus a Treasury bill or whatever or same maturity. If that spread gets too high on a 90-day basis, there will be an automatic trigger of the debt into equity. And the reason why they go back 90 days is they want to eliminate the false positive problem, that there is going to be a panic on one or two days, and then all of a sudden, you've got a spike. And then you throw the whole bank into this—

J.W. VERRET: And you minimize the manipulation.

ROBERT E. LITAN: Yes. There is a danger of manipulation and all that, and so they say we'll smooth it out if we do a 90-day average. I agree with you. I think it's a very clever idea, and I cannot give a good explanation of why it hasn't gone anywhere in the regulatory area.

I can tell you why it probably hasn't gone anywhere in the financial area, and that is that no financial institution will see it in its own interest to be first. And they're very worried about the marketability of it, it's new and so forth, and I think, frankly, the only way you're ever going to get it used is if it's mandated like a subordinated debt requirement. I can't tell you why the regulators haven't embraced it yet, and I wish there was somebody else here who would tell me that.

RANDALL D. GUYNN: So let me address that a little bit. In fact, a couple of years ago we tended to refer to these as "COCOs," because we always have little labels for things. Instead of contingent capital, COCOs are contingent convertible capital securities. There was this huge wave of interest. All of the financial institution group bankers, the so-called "FIG bankers," all over Wall Street, our phone was ringing off the hook, let's try to design this stuff, new product, we have no business, let's get some business, we can start getting people to issue these COCOs. And there have been some COCOs that have been issued in Europe, more in Switzerland and elsewhere. The problem is it's sadly turned out to be sort of an ivory-tower idea rather than one that actually works in the real world.

And here is why, and Bob actually hit on it right. It all comes down to what the trigger is and, what J.W. says, what the tax treatment is. If the trigger is late, in other words, it's like a regulatory discretion or it's at the point of non-viability—there was a big pitch about having COCOs that trigger at the point of non-viability. Well, it's too late. In fact, the COCOs become death-spiral bonds. We saw that in Japan in the early 1990s. In fact, they tend to precipitate problems. In Switzerland, they have what are called "high trigger" and "low trigger," high trigger meaning early, low trigger meaning too late, basically. So I'm not sure why you bother issuing it.

The problem with the high trigger or early trigger COCOs, at least in this country—and this is different in Europe—is if you talk to the tax lawyers—and it's funny, because you have articles by Professor Coffee and others who say, "This will work. I talked to my tax professors, and they say this is tax deductible, the interest payments on the COCOs," and when I say, "Well, gee, the tax partners at Davis Polk say it's not tax deductible," and then Professor Coffee said, "Well, my tax professors are actually former Davis Polk tax associates," my answer is "And there's a good reason why they're former David Polk associates."

RANDALL D. GUYNN: In any event, the consensus among practicing tax lawyers is you can't actually deduct it. Because they convert it into common equity, that is perpetual securities, and so the IRS just won't treat those as debt for purposes of deductibility, unless we change the law.

ROBERT E. LITAN: Change the law.

RANDALL D. GUYNN: And that's the argument. One could say this is useful enough; we should change the law.

J.W. VETTER: What I've heard at least is it's something that could be solved through IRS guidance. So if one bureaucrat of the IRS stands in the way of a sincere solution to too-big-to-fail, it just seems like such a shame.

RANDALL D. GUYNN: So it's interesting, because then you have the other problem which is pricing. But actually, if you addressed the tax issue, it might address it, because the pricing is unless your mandate was so strong to say you must issue contingent convert and you are not allowed to issue common stock, which of course seems irrational, then in fact, when you have really early COCOs—and let's set aside the tax benefit—the economic incentive is basically you look at the pricing for the issuer, and they say there is not a material difference between issuing early trigger COCOs and common stock, so I prefer to issue common stock in that case.

ROBERT E. LITAN: I'll solve that problem for you. I'll just require that you at least have a layer of 2 percent of assets of COCOs. Period. Independent of everything else. You got to meet the capital requirements. I just want you to have an additional layer of 2 percent. Period. End of subject.

RANDALL D. GUYNN: I am open to that, but I would like to see what the—I'm not quite persuaded that that's actually better than having 2 percent more of common equity. I'm not sure what you've gained from that.

MARTIN N. BAILY: Exactly.

RANDALL D. GUYNN: Exactly.

ROBERT E. LITAN: Well, if it's tax deductible, it's better because it's cheaper for the bank.

RANDALL D. GUYNN: Right. So that's why I'm saying if you believe that we can only sort of get 9 percent common equity, but we'd really like to have 10, and we'd like to get that other 2 in COCOs, and by having tax deductibility, we'll voluntarily get that extra 2, that might actually be a reason for making it tax deductible.

ROBERT E. LITAN: Right.

RANDALL D. GUYNN: I actually think the only COCOs that make sense are the ones Bob is talking about, but you just have those market issues and the tax issues that are sort of getting in the way of them.

PAUL S. ATKINS: Thanks. Next.

SAM BOWMAN: I am Sam Bowman. I'm with the Adam Smith Institute in London.

What does the panel make of the argument made by market monetarists like Scott Sumner and David Beckworth that the focus on the too-big-to-fail problem really misses the forest and focuses on the trees? And that if there is a Fed that was committed to maintaining normal GDP and preventing normal GDP from dipping after bank failures, the systemic problem would be much lower. Bank failures would be much less frequent, and ultimately, the big-bank failures would be much less important for the wider economy.

ROBERT E. LITAN: I think what he's asking —you know Scott Sumner's point about nominal GDP targeting. He is saying if you had nominal GDP targeting and you stuck to that and everybody was confident that the Fed would achieve a nominal GDP target, we wouldn't have these problems with bank failures, so end of problem. He is asking, is that the way to solve the too-big-to-fail problem?

MARTIN N. BAILY: Well, John Taylor, who is a good economist and a friend of mine, believes that it was pretty much all the result of Fed policy, and if they had just followed the Taylor rule, then we wouldn't have had the financial crisis. But I think he's in the minority, and I don't agree with him. This was a crisis that was brewed by a lot of factors—bad government policy, over-borrowing by households, and market failure in the financial sector. So just having a different Fed policy would not protect us against financial crises.

ROBERT E. LITAN: And I'll just add to that. First, the nominal GDP targeting is forward-looking. So if the losses hit today and wiped out the banks, you're screwed. The Fed can try to achieve a nominal GDP target, but just think about 2008 when nominal GDP fell enormously. It takes a heavy lift to get it back up. In the meantime, the banks have already failed.

The knowledge that the Fed is going to always maintain a nominal GDP target, would that have prevented all this subprime lending and all the other things that went wrong? No. It wouldn't have. I mean, there were other things.

SAM BOWMAN: But the argument is that even with bank failures—the first point is that lots and lots of the banks that failed didn't fail because of the initial subprime mortgage mess. It was because of other developers that lost money when the economy dipped in the secondary.

ROBERT E. LITAN: Okay, there's truth to that. The big failures didn't happen at the beginning for that reason.

SAM BOWMAN: But then the second point is that is under a stable, normal GDP regime, would bank failures matter macroeconomically?

PAUL S. ATKINS: I think we've seen the stable GDP—

MARTIN N. BAILY: On the Fed policy in this recession, the Fed is doing everything it can to get faster GDP growth, and it's pushing on a string. So, no, I don't think that would work, but it's a good issue.

PAUL S. ATKINS: I think maybe some of those folks might want to be on the Fed, which may be why they're ascribing so much foresight and power to the Fed. I think it's a bit farfetched.

One last thing, I wanted to, real quick, put this to the panel because of the constitutional lawsuits concerning Dodd-Frank. Title 2 gives a lot of authority to the various financial regulators, and so I guess that presupposes two things. One is that they'll use it wisely, if the tools are used properly, and two, it ascribes a lot of knowledge to the FDIC, which has been good at handling just one-off, relatively small bank failures in the past. But as we saw in 2008, we had a whole bunch of failures all at once. Do you all have any confidence that, first, the bank regulators will be able to live within the ambit of their Title 2 authority, and then, second, have the competence to do it?

MARTIN N. BAILY: I was a little dismayed when they said that the FDIC was going to be the authority administering Title 2, but I would say that they have stepped up to the plate in a way that surprised me, both in terms of beefing up the personnel that

they have that would be able to do this and then coming up with this single point of entry approach. So they have surprised me on that.

Am I confident that 20 years from now they won't use their discretion in a way that we might not like? Well, that is an issue. If they could have clear statements of what their policy would be under different circumstances, if we could make the bankruptcy proceeding really feasible, a Chapter 14 bankruptcy, then that might speak to the issue you're concerned about of excessive discretion.

RANDALL D. GUYNN: I think that actually is a legitimate concern that you raise, Paul, because Title 2 does give a lot of discretion. Frankly, I'd like to see some of that discretion channeled and limited, at least by a policy statement, which the FDIC has said they are going to issue sometime in the near future that would sort of outline how they're going to use it. That is not as binding as a statute, but at least if it's public and on the record, it's somewhat binding.

I also have no idea whether the policy statement will actually be in binding language or be in weasel-y language. I don't know whether it will actually have things in it that actually substantively—are stabilizing versus destabilizing. We will have to just wait and see and sort of comment on it whenever it comes out, but that would be good.

But you're right. What you'd really like to see ideally is you'd like to see Title 2 be more rules-based and maybe have things that are more binding, so that there's more predictability. That's hard to do. I can see some of the value of giving some discretion. But you're right, the problem is if you have too much discretion, you always worry about who is the person using the tool.

The one way in which I've compared this in the past is Title 2 is sort of like a power saw. It's much more effective than a handsaw. You can do a lot more in terms of building furniture and things; however, in the hands of a non-expert, it can do amazing damage. So we need to make sure that either the people using the power saw at the FDIC are experts, or we need to make sure that they are constrained by rules that make sure that that power saw gets channeled in a way that it doesn't do damage.

There will be cronyism. There will be corruption. There will be abuse of power. There will be stupidity, and this plan may be too intricate and delicate to work when we're actually in a crisis.

TIMOTHY P. CARNEY: I like the look of this plan. I hope that Randy's plan—when the stuff hits the wall, I'm going to be saying, "This is what we ought to be doing." I also think that the political pressures, the wisdom of the regulators, all that stuff, it's just the history of our government is not one that makes me have confidence that they will conduct things in such a way. There will be cronyism. There will be corruption. There will be an abuse of power. There will be stupidity, and this plan may be too intricate and delicate to work when we're actually in a crisis.

PAUL S. ATKINS: So with that, we will have to leave it to J.W. and his colleagues on the Hill to work this out and the courts to review Title 2.

Thank you all very much for your attention.

Consumer News Alert Recent Decisions

Since October 2006, the Center for Consumer Law has published the "Consumer News Alert." This short newsletter contains everything from consumer tips and scam alerts, to shopping hints and financial calculators. It also has a section just for attorneys, highlighting recent decisions. The alert is delivered by email three times a week. Below is a listing of some of the cases highlighted during the past few months. To view the full opinion, click on the link; or if that does not work, copy the link and paste it to your browser. To subscribe and begin receiving your free copy of the Consumer News Alert in your mailbox, visit the Center for Consumer Law, www.uhccl.org.

SUPREME COURT

Companies unable to remove state-brought consumer protection cases to federal court. In a unanimous decision, the United States Supreme Court held that a Mississippi parens patriae action, where the state was the sole plaintiff, did not constitute a removable CAFA mass action. The action was not removable, even if more than 100 unnamed persons were the real parties in interest who would benefit from the state's successful prosecution. The Court refused to engage in the threshold question of piercing the pleadings to determine who the real parties in interest were. Instead, the Court simply held that the parens patriae action was not a CAFA mass action, defined as any action "in which monetary relief claims of 100 or more persons are proposed to be tried jointly on the ground that the plaintiffs' claims involve common questions of law or fact." In a highly technical parsing of CAFA's statutory language, the Court declared that CAFA used the term "persons" and not "100 or more named or unnamed real parties in interest." *Mississippi ex rel. Hood v. AU Optronics Corp.*, 134 S. Ct. 736 (2014). http://www.supremecourt.gov/opinions/13pdf/12-1036_0971.pdf

CIRCUIT COURTS

FCRA limitations period runs from date plaintiff discovers creditor obtained credit report without permission. The Fifth Circuit affirmed summary judgment in favor of defendant based on section 1681p(1). The court held that in light of *Hyde v. Hibernia Nat'l Bank in Jefferson Parish,* the limitations period began to run when plaintiff discovered that defendant had obtained his credit report without his consent. *Mack v. Equable Ascent Fin., LLC*, No. 13-40128, 2014 WL 1408266 (5th Cir. Apr. 11, 2014). http://www.gpo.gov/fdsys/pkg/USCOURTS-ca5-13-40128/pdf/USCOURTS-ca5-13-40128-0.pdf

Arbitration clause survives the contract. The Sixth Circuit recently answered the question of whether an arbitration clause survives the termination of the contract containing it. A class of employees alleged FLSA violations by their employer. Each of their employment agreements had an arbitration clause and a "survival clause" which listed a few of the contractual clauses that survive termination of the agreement. But the survival clause did not mention the arbitration clause. The Sixth Circuit cited *Litton v. NLRB*, 501 U.S. 190 (1991), which "recognized a 'presumption in favor of post-expiration arbitration of disputes unless negated expressly or by clear implication [for] such disputes [arising] out of the… contract.'" Because the survival clause in the instant case was silent about arbitration as well as about other clauses that would logically survive the contract's termination, the court found that silence was not enough to expressly negate the survival of the arbitration clause. *Huffman v. Hilltop Cos., LLC*, No. 13-3938, 2014 WL 1243795 (6th Cir. Mar. 27, 2014). http://hr.cch.com/eld/6e73751c7bd410009a03e0db5501c0ed01.pdf

Debt collector's offer to "settle" a time-barred debt may violate Fair Debt Collection Practices Act. The Seventh Circuit held that debt collectors' letters to consumers offering to "settle" time-barred debts (that is, debts that would be subject to a successful statute-of-limitations defense) *could* mislead consumers and, thus, *could* violate the federal Fair Debt Collection Practices Act (FDCPA). The court stated, "The proposition that a debt collector violates the FDCPA when it misleads an unsophisticated consumer to believe a time-barred debt is legally enforceable, regardless of whether litigation is threatened, is straightforward under the statute. Section 1692e(2)(A) specifically prohibits the false representation of the character or legal status of any debt." The court emphasized that a threat of legal action is not required. "The plain language of the FDCPA prohibits not only threatening to take actions that the collector cannot take, but also the use of any false, deceptive, or misleading representation, including those about the character or legal status of any debt." The court noted that although its ruling was inconsistent with other circuits and created a circuit conflict, it was consistent with positions taken by the Federal Trade Commission and the Consumer Financial Protection Bureau. *McMahon v. LVNV Funding, LLC*, 744 F.3d 1010 (7th Cir. 2014). http://docs.justia.com/cases/federal/appellate-courts/ca7/12-3504/12-3504-2014-03-11.pdf

Arbitration agreements cannot restrict grounds for vacating award. The Ninth Circuit held that parties couldn't contractually restrict Section 10 of the FAA by providing for "binding, non-appealable arbitration." Relying on the Supreme Court opinion in *Hall Street,* the court found the statutory language in the FAA "carries no hint of flexibility," and that allowing parties to opt out of Section 10 review "would also frustrate Congress's attempt to ensure a minimum level of due process for parties to an arbitration." *In re Wal-Mart Wage & Hour Emp't Practices Litig.*, 737 F.3d 1262 (9th Cir. 2013) http://cdn.ca9.uscourts.gov/datastore/opinions/2013/12/17/11-17718.pdf

No federal presumption of arbitrability until court finds valid arbitration agreement. A recent Eleventh Circuit case discusses when the federal presumption of arbitrability applies. The court found that the presumption only applies to whether the scope of an arbitration agreement is broad enough to encompass the parties' dispute, not whether a valid arbitration agreement exists between the parties. The court noted that in *Granite Rock* SCOTUS said courts may apply "the presumption of arbitrability *only* where a validly formed and enforceable arbitration agreement is ambiguous about whether it covers the dispute at hand." It also cited the Second Circuit which has explicitly recognized that "the presumption does not apply to disputes concerning whether an agreement to arbitrate has been made." *Dasher v. RBC Bank (USA)*, 745 F.3d 1111 (11th Cir. 2014). http://www.ca11.uscourts.gov/opinions/ops/201310257.pdf

Circuit court upholds Federal Reserve debit-card transaction fees. The D. C. Circuit Court reversed a district court's decision and upheld the debit-card transaction fees regulation enacted by the Federal Reserve. The court stated:

> Combining features of credit cards and checks, debit cards have become not just the most popular noncash payment method in the United States but also a source of substantial revenue for banks and companies like Visa and MasterCard that own and operate debit card networks. In 2009 alone, debit cardholders used their cards 37.6 billion times, completing transactions worth over $1.4 trillion and yielding over $20 billion in fees for banks and networks. Concerned that these fees were excessive and that merchants, who pay the fees directly, and consumers, who pay a portion of the fees indirectly in the form of higher prices, lacked any ability to resist them, Congress included a provision in the Dodd-Frank financial reform act directing the Board of Governors of the Federal Reserve System to address this perceived market failure. In response, the Board issued regulations imposing a cap on the per-transaction fees banks receive and, in an effort to force networks to compete for merchants' business, requiring that at least two networks owned and operated by different companies be able to process transactions on each debit card. Merchant groups challenged the regulations, seeking lower fees and even more network competition. The district court granted summary judgment to the merchants, concluding that the rules violate the statute's plain language. We disagree. Applying traditional tools of statutory interpretation, we hold that the Board's rules generally rest on reasonable constructions of the statute, though we remand one minor issue—the Board's treatment of so-called transactions-monitoring costs—to the Board for further explanation.

Combining features of credit cards and checks, debit cards have become not just the most popular noncash payment method in the United States but also a source of substantial revenue for banks and companies like Visa and MasterCard that own and operate debit card networks.

NACS v. Bd. of Governors of the Fed. Reserve Sys., No. 13-5270, 2014 WL 1099633 (D.C. Cir. Mar. 21, 2014). http://h2o.law.harvard.edu/cases/4290

Under the Credit Repair Organizations Act, a person need not actually provide credit repair services. The Ninth Circuit reviewed the language of the CROA, and concluded that a company that advertised it would provide a service for the purpose of assisting a consumer in improving the consumer's credit record, history or rating was within the scope of the CROA. " From the plain language of the statute, it is clear that under the CROA, a person need not actually provide credit repair services to fall within the statutory definition of a credit repair organization. Instead, the person need only *represent* that it can or will sell, provide, or perform a service for the purpose of providing advice or assistance to a consumer with regard to improving a consumer's credit record, credit history, or credit rating." *Stout v. FreeScore, LLC*, 743 F.3d 680 (9th Cir. 2014). http://cdn.ca9.uscourts.gov/datastore/opinions/2014/02/21/10-56887.pdf

Credit card fees are not unconstitutional. The Ninth Circuit held that cardholders do not have a claim that fees imposed by the issuer violate substantive due process. The court noted that the jurisprudence developed to limit punitive damages in the tort context does not apply to contractual penalties, such as the credit card fees at issue. *In re Late Fee & Over-Limit Fee Litig.*, 741 F.3d 1022 (9th Cir. 2014). http://caselaw.findlaw.com/us-9th-circuit/1655200.html

One-sidedness is not a defense to an arbitration clause. The Tenth Circuit held that a "business-goes-to-court-but-consumer-goes-to-arbitration" agreement, even if unconscionable under state law, is enforceable under the FAA. The court stated:

> "Under New Mexico law a compulsory-arbitration provision in a contract may be unconscionable, and therefore unenforceable, if it applies only, or primarily, to claims that just one party to the contract is likely to bring. The question before us is whether the Federal Arbitration Act (FAA) preempts this state law for contracts governed by the FAA. We hold that New Mexico law is preempted in this case and the arbitration clause must be enforced."

The court noted that the reasoning that supports a finding of unconscionability is based on a belief that arbitration is inferior to a judicial proceeding. According to the court, this reasoning is flawed. "In other words, just as the FAA preempts a state statute that is predicated on the view that arbitration is an inferior means of vindicating rights, it also preempts state common law—including the law regarding unconscionability—that bars an arbitration agreement because of the same view." *THI of N.M. at Hobbs Ctr., LLC v. Patton*, 741 F.3d 1162 (10th Cir. 2014). http://www.ca10.uscourts.gov/opinions/13/13-2012.pdf

Right of rescission expires in three years. The Sixth Circuit noted that the right of rescission under Truth in lending expires three years after the date of the consummation of the transaction. The court held this means a lawsuit must be filed within that time period, regardless of whether the creditor was notified of the rescission. *Lumpkin v. Deutsche Bank Nat'l Trust Co.*, 534 Fed. Appx. 335 (6th Cir. 2013).
https://casetext.com/case/lumpkin-v-deutsche-bank-natl-trust-co#document_text

Suit filed after statute of limitations has run violates FDCPA. The Seventh Circuit held that a lawsuit filed after the limitations period violated the Fair Debt Collection Practices Act. The court also found the named plaintiff to be an adequate representative, despite allegations her claim was not typical and she would not have the incentive to represent all class members. *Phillips v. Asset Acceptance, LLC*, 736 F.3d 1076 (7th Cir. 2013).
http://docs.justia.com/cases/federal/appellate-courts/ca7/13-2251/13-2251-2013-12-02.pdf

Right of rescission expires upon the sale of property. Notice of rescission is not sufficient to exercise the right of rescission. The Eight Circuit held that a consumer did not preserve his right of rescission simply by giving notice prior to the foreclosure sale of his property. *Hartman v. Smith*, 734 F.3d 752 (8th Cir. 2013). http://media.ca8.uscourts.gov/opndir/13/08/121947P.pdf

Creditor found liable under FDCPA for using a name other than its own when collecting its debts. The Second Circuit held that a creditor is liable under the FDCPA when it used a law firm to send collection letters to debtors. *Vincent v. Money Store*, 736 F.3d 88 (2nd Cir. 2013). http://www.gpo.gov/fdsys/pkg/USCOURTS-ca2-11-04525/pdf/USCOURTS-ca2-11-04525-0.pdf

DISTRICT COURTS

Hyperlinked waivers are enforceable. The District Court for the Southwestern District of New York held that class action waivers and arbitration clauses in consumer contracts are enforceable, even if the provisions must be accessed via a series of two successive hyperlinks from the agreement sign-up box. *Starke v. Gilt Groupe, Inc.*, No. 13 Civ. 5497(LLS), 2014 WL 1652225 (S.D.N.Y. Apr. 24, 2014). http://digitalcommons.law.scu.edu/cgi/viewcontent.cgi?article=1711&context=historical

FTC has authority over American Indian tribe lending. A federal district court in Nevada found that "the FTC Act is a federal statute of general applicability that under controlling Ninth Circuit precedent grants the FTC authority to regulate arms of Indian tribes, their employees, and their contractors." The court relied on Ninth Circuit precedent, finding "[t]he Federal Trade Commission … has broad powers under the FTC Act to prevent businesses from engaging in unfair or deceptive practices." *F.T.C. v. AMG Servs., Inc.*, No. 2:12-CV-00536-GMN, 2014 WL 910302 (D. Nev. Mar. 7, 2014).
http://www.manatt.com/uploadedFiles/Content/4_News_and_Events/Newsletters/BankingLaw@manatt/FTC-v-AMG-Services.PDF

Court finds TCPA consent based on ten-year old conduct. An Illinois District court used ten-year old proof that a consumer gave his phone number as his contact point to satisfy the express consent defense under the TCPA. The court described the express consent defense as follows: "[P]ersons who knowingly release their phone numbers have in effect given their invitation or permission to be called at the number which they have given, absent instructions to the contrary." The plaintiff had filled a prescription at a Walgreens pharmacy in 2002, when he provided his cellular phone number to a Walgreens pharmacist "who told him that his number was needed for potential identity verification purposes." The court found that because plaintiff had elected to provide his cellular telephone number as his point of contact ten years earlier, and never provided Walgreen Co. with "instructions to the contrary," the mere passage of time could not vitiate consent, opining that "consent under the TCPA does not expire on its own; it must be revoked." *Kolinek v. Walgreen Co.*, No. 13 C 4806, 2014 WL 518174 (N.D. Ill. Feb. 10, 2014). http://www.gpo.gov/fdsys/pkg/USCOURTS-ilnd-1_13-cv-04806/pdf/USCOURTS-ilnd-1_13-cv-04806-0.pdf

DECEPTIVE TRADE PRACTICES AND WARRANTIES

MORTGAGOR IS NOT CONSUMER UNDER DTPA

James v. Wells Fargo Bank, N.A., 533 F. App'x 444 (5th Cir. 2013).

FACTS: Plaintiffs, Tommy James and Sherry Airhart ("James"), were homeowners whose loan was owned by Federal Home Loan Mortgage Corporation ("Freddie Mac") and serviced by Defendant, Wells Fargo Bank, N.A. ("Wells Fargo"). After defaulting on payment obligations, James sought to modify the loan under the Home Affordable Modification Program ("HAMP"). Wells Fargo denied the application and foreclosed on the house.

James sued Wells Fargo, alleging various causes of action, including violation of the Texas Deceptive Trade Practices Act ("DTPA"). Wells Fargo removed the case and moved to dismiss. The district court granted the motion.
HOLDING: Affirmed.
REASONING: James' DTPA claim failed as a matter of law, because James was not a consumer within the meaning of the Act. James did not seek or acquire goods or services as defined in the Act. A person cannot qualify as a consumer if the underlying transaction is a pure monetary loan, because lending money is considered neither a good nor a service. Furthermore, Texas federal courts have recently addressed similar DTPA claims and determined that a person seeking a loan modification under the HAMP while using a loan servicer does not qualify as a consumer.

A person cannot qualify as a consumer if the underlying transaction is a pure monetary loan.

A PARTY IS NOT A DTPA CONSUMER WHEN IT ARRANGES FOR SERVICES TO BE PROVIDED TO ANOTHER

Coinmach Corp. v. Aspenwood Apartment Corp., 417 S.W.3d 909 (Tex. 2013).

FACTS: Respondent, Aspenwood Apartment Corporation ("Aspenwood"), sued its lessee, Petitioner, Coinmach Corporation ("Coinmach"), for violations of the Deceptive Trade Practices Act ("DTPA"). Coinmach leased laundry rooms and operated its own machines in an apartment complex that Aspenwood bought in a foreclosure sale. Upon purchase, Aspenwood immediately gave Coinmach written notice to vacate the laundry rooms, asserting that the foreclosure sale had terminated their lease and that Coinmach had failed to safely and adequately maintain the equipment. After Coinmach did not vacate, Aspenwood asserted DTPA violations against Coinmach.

Coinmach moved for summary judgment for Aspenwood's DTPA claims. The trial court granted Coinmach's motion for summary judgment on the ground that Aspenwood was not a "consumer." The court of appeals affirmed, and Aspenwood appealed to the Supreme Court of Texas.
HOLDING: Affirmed.
REASONING: The court first discussed that the DTPA defines a "consumer" as "one who seeks or acquires by purchase or lease, any goods or services." The Court held that Aspenwood had not sought or acquired goods or services from Coinmach. Coinmach leased premises within Aspenwood's complex and paid rent, and while Aspenwood was entitled to rent payments, it was not itself a consumer of Coinmach's services.

The Court further stated that a party is not a consumer when it merely arranges for a service to be provided to its customers, even if it indirectly benefited from the service. The purpose of Coinmach's lease was to provide services to Aspenwood's tenants, not to Aspenwood itself. While Aspenwood received indirect benefits from Coinmach's services, the Court held that those services did not qualify Aspenwood as a consumer under the DTPA.

CONSUMER MUST ESTABLISH REPRESENTATION WAS A "PRODUCING CAUSE" OF DAMAGES

Bryant v. S.A.S., 416 S.W.3d 52 (Tex. App.—Houston [1st Dist.] 2013).

FACTS: Plaintiffs, the Smiths, learned about Defendant, Morgan Bryant's ("Bryant"), babysitting services from a flyer his mother, a Co-Defendant, circulated at Atascocita United Methodist Church endorsing his services. The Smiths decided to hire Bryant based on the information in the flyer. Bryant babysat for the Smiths several times, and eventually the children revealed that Bryant had molested them. Bryant pled guilty to felony charges.

The Smiths filed a DTPA claim against Bryant and his mother in connection with the representations on the flyer. The trial court entered judgment for the Smiths. Bryant appealed.
HOLDING: Reversed.
REASONING: The court listed the four elements a plaintiff must prove in a DTPA claim: (1) the plaintiff was a consumer; (2) the defendant engaged in one of a list of the activities or practices prohibited by the statute; (3) the plaintiff detrimentally relied on the false, misleading, or deceptive act or practice; and (4) the false, misleading, or deceptive act or practice was a producing cause of the plaintiff's injury. The court explained that the Smiths had to prove a cause-in-fact in order to show a producing cause, and that Bryant's misrepresentation were a substantial factor in causing the Smiths' injuries that otherwise would not have occurred.

The court clarified that even if the injury would not have happened but for Bryant's conduct, the connection may still be too attenuated to constitute legal cause. The court determined the evidence of the Smiths' hiring process showed a diminished link between misrepresentations and injuries, even if they had first relied on the flyer. The court ruled that the connection between the representations in the flyer and Bryant's presence in the Smiths' home was too attenuated to cause their injuries. Accordingly, because the Smiths failed to show a cause-in-fact, they failed to show the producing cause as required by the DTPA.

The dissent, however, took direction from the Texas Supreme Court, which has stated that producing cause and cause-in-fact are conceptually identical. From this, the dissent argued that because the Smiths testified that they would not have hired Bryant but for the representations of his mother, they had indeed shown producing cause.

CONSUMER CREDIT

RIGHT OF RECESSION EXPIRES AFTER THREE YEARS

Lumpkin v. Deutsche Bank Nat'l Trust Co., 534 F. App'x 335 (6th Cir. 2013).

FACTS: Plaintiff, Croffort E. Lumpkin, Jr. ("Lumpkin"), purchased a home and borrowed against the property on May 18, 2007. Lumpkin stopped making payments on the loan in April 2009 and defaulted. In May 2009, Lumpkin's non-attorney agent sent a letter to the creditor demanding copies of all documents pertaining to the origination of the mortgage. In February 2010, the mortgage was assigned to Defendant, Deutsche Bank National Trust Company ("Deutsche Bank"), who initiated foreclosure and soon thereafter purchased the property at a sheriff's sale.

Lumpkin sued under the Truth in Lending Act ("TILA"), which allows a buyer to bring a claim for rescission if certain disclosures are not made. The district court granted summary judgment against Lumpkin, holding that the TILA claim was time-barred. Lumpkin appealed.

HOLDING: Affirmed.

REASONING: TILA allowed a seller to bring a claim for rescission if certain disclosures are not made. 15 U.S.C. §1635(a) gives the debtor the right to rescind for three business days from the later of either the date of the transaction or the date the required forms and disclosures are delivered. However, 15 U.S.C. §1635(f) states that there is an absolute three-year time limit in which a debtor may exercise his right of rescission, regardless of whether the required disclosures were delivered to the debtor. The Supreme Court explained in *Beach v. Ocwen Federal. Bank* that §1635(f) is silent on bringing an action, rather providing that the right of rescission expires at the end of the time period.

Regardless of when and whether Lumpkin notified the creditor, Lumpkin's right to file suit for rescission expired three years after the sale of the property

Lumpkin argued that his May 2009 letter exercised his right of recession a year before the statutory period ran. This appellate court agreed with the district court that the rescission did not occur for two reasons. First, the May 2009 letter made no mention of rescission or TILA, and consequently was not a notification of rescission. Second, Lumpkin misinterpreted the right of rescission under TILA. Regardless of when and whether Lumpkin notified the creditor, Lumpkin's right to file suit for rescission expired three years after the sale of the property in May 2010.

UNDER THE CREDIT REPAIR ORGANIZATIONS ACT, A PERSON NEED NOT ACTUALLY PROVIDE CREDIT REPAIR SERVICES

Stout v. FreeScore, L.L.C., 743 F.3d 680 (9th Cir. 2014).

FACTS: Appellant, Kevin Stout ("Stout"), sued Appellee, FreeScore, L.L.C. ("FreeScore"), alleging violations of the Credit Repair Organizations Act ("CROA"). Stout subscribed to services offered by FreeScore and paid a monthly fee. Stout alleged that FreeScore utilized its website, commercials, and social media outlets to represent its services providing assistance in repairing an individual's credit. Stout also alleged that FreeScore is a "credit repair organization," as defined by the CROA.

FreeScore moved to dismiss the suit, and the trial court granted its motion. The court determined that FreeScore was not a credit repair organization in the context provided by the CROA, because it promised merely to provide consumers their credit scores, leaving it to consumers to separately repair their credit. Stout appealed.

HOLDING: Reversed and remanded.

REASONING: The court looked to the plain language of the CROA. A "credit repair organization" need only represent that it can or will sell, provide, or perform a service for the purpose of providing advice or assistance to a consumer with regard to improving a consumer's credit history or rating. FreeScore advertised not only its credit report services, but also its credit monitoring services as a tool for repairing damaged credit. The court looked to the overall impression the advertisements had on consumers and found that FreeScore fit within the CROA's definition of a "credit repair organization."

The court also held that FreeScore's disclaimer that it was not a "credit repair organization" did not defeat representations that it made about its services. To qualify as a "credit repair organization" under the CROA, a person or entity need not have literally provided credit repair services; instead, it is merely required to have given the "overall net impression" of offering advice or assistance aimed at improving consumer credit.

CREDIT CARD FEES ARE NOT UNCONSTITUTIONAL

In re Late Fee & Over-Limit Fee Litig., 741 F.3d 1022 (9th Cir. 2014).

FACTS: Appellants, a class of credit card holders ("Cardholders"), sued Appellees, a group of the largest credit card issuers ("Issuers"), on the constitutionality of overage fees and late fees. The Issuers charged uniformly over the credit limit or late monthly balance payment fees. The Cardholders alleged these charges exceeded the harm the Issuers suffered and were unconstitutional punitive damages.

The Issuers moved to dismiss the claim. The district court granted the motion, and the Cardholders appealed.

HOLDING: Affirmed.

REASONING: The court looked to the policy behind punitive damages. Punitive damages are not meant to compensate but are aimed principally at retribution and deterring harmful conduct. Punitive damages are authorized in contract actions to the extent the Constitution allows.

The court acknowledged the difference between the parties entering into private adhesive contracts with penalty clauses versus jury-determined punitive damage awards. The court emphasized that the penalty clauses at issue originated from the par-

ties' private contracts, which may be oppressive and unjust based on the common law of contracts, but not based on constitutional principles. Therefore, the Cardholders' argument regarding the constitutionality of jury-awarded punitive damages did not apply.

F.T.C. HAS AUTHORITY OVER AMERICAN INDIAN TRIBE LENDING

F.T.C. v. AMG Servs., Inc., (D. Nev. 2014) (not designated for publication).

FACTS: Plaintiff, the Federal Trade Commission ("FTC"), sued Defendant, AMG Services, Inc. ("AMG"), for violations of the Federal Trade Commissions Act ("FTC Act"). The FTC alleged AMG engaged in deceptive acts by providing and collecting on short-term, high-interest payday loans to consumers.

The court concluded that the purpose of the FTC Act is to prevent and prosecute unfair and deceptive acts that affect commerce.

AMG argued that the FTC did not have the authority to regulate Indian Tribes, nor could the FTC regulate lending activities of the Tribal Chartered defendants. The FTC filed a motion for partial summary judgment to dismiss AMG's defenses, arguing that the FTC does have the authority to regulate Indian Tribe lending under the FTC Act.

HOLDING: Granted.

REASONING: The court looked to sister jurisdictions' interpretations of federal statutes, finding most broad statutes, like the FTC Act, had been generally held applicable to Indian Tribes, unless they contained an express exemption. While AMG argued that they were exempt from the FTC Act as a sovereign tribal entity, the court determined that when a federal statute with general applicability was silent on tribal exemptions, it presumptively applied to tribes.

The court concluded that the purpose of the FTC Act is to prevent and prosecute unfair and deceptive acts that affect commerce. Because AMG's actions were deceptive lending practices, the FTC had authority to prosecute AMG under the FTC Act.

CIRCUIT COURT UPHOLDS FEDERAL RESERVE DEBIT-CARD TRANSACTION FEES

NACS v. Bd. of Governors of Fed. Reserve Sys.,____ F.3d ____ (D.C. Cir. 2014).

FACTS: To prevent debit-card fee transaction increases, Congress passed the Durbin Amendment as part of the 2010 Dodd-Frank Act, which modified the Electronic Funds Transfer Act ("EFTA"). The Durbin Amendment contains two key provisions.

First, Section 920(a), restricts the amount of interchange fees. Appellant, Board of Governors of the Federal Reserve System (the "Board"), was instructed to promulgate regulations to ensure reasonable and proportional interchange transaction fees. Further, the Board was to distinguish between incremental costs for authorization, clearance, and settlement ("ACS"). Second, §920(b) prohibits certain exclusivity and routing priority agreements. The Board was instructed to promulgate regulations preventing any issuer or network from restricting the election of processing networks by a merchant, so to drive down debit-card fees.

In its final rule, the Board increased the interchange fee limits for ACS costs to double the amount established in its proposed rule and selected a less restrictive anti-exclusivity networking option. Appellees, NACS, and other merchant groups, filed suit alleging that the final rule violated the plain terms of the Durbin Amendment. The district court granted summary judgment to NACS on the basis that the Board erred and failed to carry out Congress intent. The district court also vacated and remanded the interchange fee rule and the anti-exclusivity rule. The Board appealed.

HOLDING: Reversed and remanded.

REASONING: The Durbin Amendment is ambiguous as to whether the Board should consider only two categories of costs or include an implicit third category of costs. Applying the *Chevron* two-step deference standard, the court found that the Board's final rule was a reasonable interpretation of the Durbin Amendment.

The court then looked to whether the Board reasonably concluded that issuers could recover four specific types of costs challenged by the merchants: (1) "fixed" ACS costs; (2) network processing fees; (3) fraud losses; and (4) transaction-monitoring costs. The court found that allowing issuers to recover fixed ACS costs was reasonable because a distinction between fixed and variable costs is unworkable. The court also noted that permitting costs incurred in the course of effecting transactions was reasonable because it prevented issuers and networks from circumventing the interchange fee rules. Finally, the issuers' ability to recover fraud losses through the reasonable and proportional interchange fees was reasonable based on the board's policy considerations.

The court remanded the issue of transaction-monitoring costs because the appellate record was incomplete on this matter. The court, however, agreed that the Board had discretion to allow issuers to recover transaction-monitoring costs through the interchange fee regardless of compliance with fraud-prevention standards.

RIGHT OF RESCISSION EXPIRES UPON THE SALE OF PROPERTY

NOTICE OF RESCISSION IS NOT SUFFICIENT TO EXERCISE THE RIGHT OF RESCISSION

Hartman v. Smith, 734 F.3d 752 (8th Cir. 2013).

FACTS: Plaintiffs, Roger and Mavis Hartman ("Hartman"), received financing for construction of their house from Defendants, Brian and Jennifer Smith, ("Smith") in a complex and unconventional real estate financing arrangement. Hartman conveyed his house to Smith, who then placed a mortgage on the house and obtained a loan from co-Defendants, Prime Security Bank ("Prime"). Smith agreed to re-convey the house back to Hartman upon repayment of the loan. Hartman stopped making loan payments to Smith, and Smith stopped making the mortgage payments to Prime. Prime foreclosed on the house, and it was sold at a sheriff's sale. Following the sale, Hartman filed suit in district

court seeking rescission of the loan agreement, pursuant to the Truth in Lending Act ("TILA").

The district court granted partial summary judgment in favor of both Smith and Prime. Hartman appealed and Prime cross-appealed.

HOLDING: Affirmed in part, reversed in part.

REASONING: Hartman argued that the district court erred in granting summary judgment to Prime on their TILA rescission claim. Prime asserted that Hartman's right to rescind under TILA was barred by statute because Hartman's actions did not commence until after the house had been sold. Under TILA, in any consumer credit transaction in which a security interest is retained in property used as the principal dwelling of the person to whom the credit is extended a consumer has the right to rescind a transaction by notifying the creditor. The court accepted Prime's argument that under §1635(a), an obligor's right of rescission expires three years after the date of consummation of the transaction or upon the sale of the property. Hartman's house was sold at the sheriff's sale, which extinguished Hartman's right of rescission.

Prime argued that Hartman needed to file a lawsuit in order to exercise the TILA statutory right of rescission. The court accepted this argument as well.. The court noted there is a circuit split as to whether the borrower must file a lawsuit to exercise the right to rescind or whether the borrower need only assert that right through a written notice. This court had recently agreed with the Ninth and Tenth Circuits that the borrower must assert rescission in a legal action to fully exercise the right of rescission. The court explained that Hartman's notice of rescission was not in and of itself sufficient to exercise the right. Because Hartman did not file suit for rescission prior to the foreclosure sale, they no longer had the right to seek rescission of the transactions.

In affirming in part and reversing in part, the court ruled in favor of Prime on both issues, granting Prime's motion for summary judgment.

DEBT COLLECTION

CREDITOR FOUND LIABLE UNDER FDCPA FOR USING A NAME OTHER THAN ITS OWN WHEN COLLECTING ITS DEBTS

Vincent v. The Money Store, 736 F.3d 88 (2nd Cir. 2013).

FACTS: Plaintiff, Vincent, defaulted on his mortgage. Defendant, The Money Store, serviced Vincent's loans. The Money Store contracted with a third party law firm to send Vincent notices; Vincent received a letter from the law firm informing him of his default. The letters were printed on the law firm's letterhead and stated that the law firm had been retained in order to collect The Money Store's debts. The letters, however, functioned only as notice of Vincent's default, as the letter further stated that all communications about the default must be made through The Money Store.

The FDCPA does not generally regulate creditors collecting their own accounts.

Vincent filed suit alleging that The Money Store violated the Fair Debt Collection Practices Act ("FDCPA") by hiring the law firm to send out collection letters falsely indicating that the law firm had been retained to collect its debts when, in fact, The Money Store was still collecting its own debts. The district court granted summary judgment in favor of The Money Store.

HOLDING: Vacated in part and remanded.

REASONING: The court explained that the FDCPA does not generally regulate creditors collecting their own accounts. However, when a creditor in the process of collecting its own debts hires a third party for the express purpose of representing to its debtors that the third party is collecting the creditor's debts, and the third party engages in no bona fide effort to collect those debts, the false name exception under 15 U.S.C. §1692a(6) exposes the creditor to FDCPA liability.

The court analyzed the three elements that must be satisfied before deeming a creditor a debt collector pursuant to the false name exception: (1) the creditor is collecting its own debts; (2) the creditor uses a name other than its own; and (3) the creditor's use of that name falsely indicates that a third person is collecting or attempting to collect the debts that the creditor is collecting.

The court found that there was no dispute as to the first element; The Money Store was collecting its own debts. As to the second element, the court found that The Money Store did use a name other than its own by sending breach letters which appeared to be attorney collection letters as indicated by the use of the law firm's name and letterhead.

The court adopted the "conduit test," which distinguishes a debt collector who undertakes collection activity separately from the creditor, and a third party merely acting as a conduit for a collections process controlled by the creditor. In the first instance, the creditor would not be liable as a bona fide attempt by the debt collector to collect the debt but in the second instance, the creditor would be liable under the FDCPA.

The court held that determining the nature of the debt collection activity was a question of fact, and the district court erred in granting The Money Store's motion for summary judgment. The court concluded that if the breach letters falsely indicated that the third party law firm was collecting or attempting to collect The Money Store's debts, The Money Store could be held liable under the FDCPA according to the false name exception. The court vacated the dismissal of the claims and remanded.

SUIT FILED AFTER STATUTE OF LIMITATIONS HAS RUN VIOLATES FDCPA

Phillips v. Asset Acceptance, L.L.C., 736 F.3d 1076 (7th Cir. 2013).

FACTS: Appellee, Asset Acceptance ("Asset"), a debt collector, sued appellant Gwendolyn Phillips ("Phillips"), for a debt arising from a contract for the sale of goods. Phillips countersued, claiming that the charges against her and others similarly situated were filed after the statute of limitations on the creditor's

claim had expired, violating the Fair Debt Collection Practices Act ("FDCPA").

The district court denied Phillips's motion to certify a class because the class was not similarly situated and different limitation periods applied to different defendants. Phillips appealed.

HOLDING: Reversed and remanded.

REASONING: The court first addressed the policy concerns behind prohibiting debt collection suits filed after limitations ran. After a long period of time, the consumer is subject to unfair circumstances, such as the loss of relevant records, dulled memory, attorneys' fees, and unfamiliarity of the applicable statute of limitations. Debt collectors often filed these suits after limitations ran to pressure the consumer into paying the debt, which is what the FDCPA prohibits.

The court held that if the debt collection suits were filed after the statute of limitations had run, they were time-barred and violated the FDCPA. Asset's cause of action could have been saved by showing that the violation was not intentional and resulted from a bona fide error, under 15 U.S.C. §1692k(c), or through an equitable tolling or equitable estoppel defense, to bar the statute of limitations. The court found one limitation period applied to all proposed class members, and reversed the district court's ruling on Phillips's motion.

FOURTH CIRCUIT HOLDS FDCPA PERMITS ORAL DISPUTES OF DEBT

Clark v. Absolute Collection Serv., Inc., 741 F.3d 487 (4th Cir. 2014).

FACTS: Appellants, Dana and David Clark ("Clark"), incurred two debts at a health care facility. When Clark was unable to pay, the health care facility referred the debts to a third-party collector, Appellee, Absolute Collection Service ("ACS"). ACS sent Clark collection notices, which contained disclosures stating, "[a]ll portions of this claim shall be assumed valid unless disputed in writing within thirty (30) days."

Clark sued ACS in a putative class action suit for failing to comply with the Fair Debt Collection Practices Act ("FDCPA"), claiming that ACS violated their right to challenge their debt orally under §1692g(a)(3) of the FDCPA. ACS moved to dismiss arguing that §1692g(a)(3) contained an inherent writing requirement and that Clark had failed to state a claim. The district court granted ACS's motion, and Clark appealed.

HOLDING: Vacated and remanded.

REASONING: The Fourth Circuit reviewed §1692 of the FDCPA and determined that written communication from consumers is not required in all instances. Sections 1692g(a)(4), 1692g(a)(5), and 1692g(b) required consumers to contact debt collectors in writing, but 1692g(a)(3) did not. The court refused to find an implied requirement of written communication into §1692g(a)(3) because it is generally presumed that Congress acts intentionally and purposefully when including particular language in one section of a statute, but omitting it in another.

Additionally, the court looked to well-established principles of statutory construction, and felt bound to give effect to every clause and word of a statute whenever possible. The court explained that relying on the writing requirements in §§1692g(a)(4), 1692g(a)(5), and 1692g(b) to give effect to §1692g(a)(3) would violate that principle and render §1692g(a)(3) meaningless on its own. Thus, §1692g(a)(3) provided consumers statutory protections that were independent of those provided by §§1692g(a)(4), 1692g(a)(5) and 1692g(b). In making this determination, the court created a bifurcated scheme of consumer rights and agreed with the Second and Ninth Circuits that the text of §1692g(a)(3) permitted oral disputes of debt.

UNDER FAIR DEBT COLLECTION PRACTICES ACT ACTIONS OF DEBT COLLECTOR ARE EVALUATED BY "UNSOPHISTICATED CONSUMER" STANDARD

Royal Fin. Group, L.L.C. v. Perkins, 414 S.W.3d 501 (Mo. Ct. App. 2013).

FACTS: Appellee, Royal Financial Group ("Royal"), brought action against Appellant, Perkins, for breach of contract and attorneys' fees. Perkins counterclaimed, alleging Royal's debt collection practices violated the Fair Debt Collection Practices Act ("FDCPA"). The trial court dismissed Royal's petition for failure to comply with discovery. In regard to Perkins's counterclaim, the trial court concluded that Perkins's evidence insufficiently supported the FDCPA claims and ruled in favor of Royal. Perkins appealed.

HOLDING: Reversed and remanded.

REASONING: The court first determined whether Royal used false, deceptive, or misleading representations or means to collect debt. A debt collector's actions are evaluated through the lens of an unsophisticated consumer, meaning one who has below average sophistication or intelligence. Statements contained in pleadings and other court filings are actionable under the FDCPA. Perkins alleged that Royal made false claims in its pleading because Royal asserted that it was an assignee of Chase Manhattan Bank in its petition, but later admitted that it possessed no documentation linking the chain of ownership to Chase. The court held that the record could support no other finding but that Royal's assertion was false, or in the very least, misleading from the perspective of an unsophisticated consumer.

A debt collector's actions are evaluated through the lens of an unsophisticated consumer, meaning one who has below average sophistication or intelligence.

The court next determined whether Royal falsely represented that it was entitled to collect attorneys' fees. A collector violates the FDCPA by requesting fees to which it is not entitled under the law. A collector's unfounded claim for attorneys' fees can constitute deceptive means to collect debt under the FDCPA because the consumer might feel pressured to immediately settle the debt, regardless of its validity. The court determined that Royal insufficiently produced evidence of its alleged entitlement to attorneys' fees beyond an unauthenticated boilerplate cardholder agreement, which prior holdings deemed inadequate as a basis to support a collector's claim. The court held that Royal's petition itself, viewed from the perspective of an unsophisticated

consumer, was a deceptive attempt to collect a debt that Royal could not legally collect.

CLAIMS UNDER THE FAIR DEBT COLLECTION PRACTICES ACT ARE EVALUATED UNDER THE OBJECTIVE "UNSOPHISTICATED CONSUMER" STANDARD

Gruber v. Creditors' Prot. Serv., Inc., 742 F.3d 271 (7th Cir. 2014).

FACTS: Appellant, John Gruber ("Gruber"), received a debt collection notice from Appellee, Creditors' Protection Service ("CPS"). The Fair Debt Collection Practices Act ("FDCPA") required CPS to include a statement in the letter that if the consumer notified the debt collector within thirty days, disputing all or part of the debt in writing, the debt collector would obtain verification of the debt or a copy of a judgment against the consumer. The debt collector would then mail a copy of such verification or judgment to the consumer. CPS included a similar statement but omitted the phrase "that the debt, or any portion thereof, is disputed."

The district court dismissed the suit for failure to state a claim. Gruber appealed.

HOLDING: Affirmed.

REASONING: Gruber argued that the notice from CPS was misleading in that it directed consumers to request verification from the collector instead of dispute the debt. The court rejected this argument by explaining that claims under the FDCPA are evaluated from the "unsophisticated consumer" standard, not the least sophisticated consumer standard. The unsophisticated consumer has some basic knowledge of the financial world, is able to read financial notices with added care, is reasonably intelligent, and is capable of making logical conclusions and inferences. The court added that unless a significant portion of the population would have been misled, the action should be dismissed. The court held that letters of notice sent by CPS were not misleading and complied with the FDCPA.

DEBT COLLECTOR DOES NOT HAVE TO PARROT LANGUAGE TO COMPLY WITH FDCPA

Wallace v. Diversified Consultants, Inc., ____ F.3d ____(6th Cir. 2014).

FACTS: Appellant, Carl Wallace ("Wallace"), a debtor, sued Appellee, Diversified Consultants, Inc. ("Diversified"), a creditor, for violating the Fair Debt Collection Practices Act ("FDCPA"). Diversified notified Wallace that it would assume the validity of Wallace's debt unless he disputed it "within 30 days of receiving the notice." Wallace found issue with this phrasing, as it did not use the verbatim language of the FDCPA, which states "within 30 days after receiving the notice."

The district court disagreed with Wallace and granted a judgment on the pleadings in favor of Diversified. Wallace appealed.

HOLDING: Affirmed.

REASONING: The court held that a debt collector does not have to parrot the language of the FDCPA to comply with the notice requirement. The court stated that a notice complies with the FDCPA if it speaks with enough clarity to convey the required information to a reasonable but unsophisticated consumer. The court decided that Diversified's letter adequately informed Wallace of the 30-day period to dispute the debt before the validity of the debt would be assumed. The court stated that using "of" or "after" did not matter and referred to other literary works that use the two words interchangeably.

Wallace also argued that "of" and "after" were ambiguous as to when to start counting the days. The court agreed, but said that it did not matter because the results would be the same either way. The FDCPA did not say whether the day the letter had been received by the debtor counts, so this argument did not make a difference as to the notice.

DEBT COLLECTOR CANNOT USE BONA FIDE ERROR DEFENSE

Engelen v. Erin Capital Mgmt., L.L.C., 544 F. App'x. 707 (9th Cir. 2013).

FACTS: Appellee, Rosen & Loeb, was hired to collect a debt of Appellant, Arthur Engelen ("Engelen"). Rosen & Loeb's bookkeeper entered payments into their collection software for calculation. Rosen & Loeb's office manager periodically spot-checked the payment to make sure that the payments were accurately credited. Rosen & Loeb unjustly garnished Engelen's wages even though Engelen had already satisfied the debt because its bookkeeper failed to record Engelen's payment.

The bona fide error defense is a narrow exception to strict liability under the FDCPA.

Engelen filed suit against Rosen & Loeb under the Fair Debt Collection Practices Act ("FDCPA"). The district court granted summary judgment in favor of Rosen & Loeb, and Engelen appealed.

HOLDING: Reversed.

REASONING: The court sought to determine whether the bona fide error defense shielded Rosen & Loeb from liability under the FDCPA. The bona fide error defense is a narrow exception to strict liability under the FDCPA. Defendants bear the burden of proof at summary judgment. In order for the bona fide error defense to apply, defendants must prove the error was: (1) unintentional; (2) bona fide, meaning made in good faith; and (3) resulted notwithstanding reasonably adapted procedures to avoid it.

According to the court, Rosen & Loeb's procedures, which consisted of legal compliance training, a written policy describing how payment notifications were to be handled, and periodic spot-checking of the bookkeeper's work, were not reasonably adapted to avoid error. Rosen & Loeb neither presented evidence of any regular redundancies designed to catch human recording errors nor contacted the debtor or the court before filing a Writ of Execution and garnishing Engelen's wages. Because Rosen & Loeb failed to meet its burden of proof as to its entire set of procedures under the bona fide error defense, the court concluded that Rosen & Loeb was not entitled to summary judgment.

ARBITRATION

ARBITRATION AGREEMENT IN ATTORNEY'S RETAINER AGREEMENT MUST BE FULLY DISCLOSED

Smith v. JEM Group, Inc., 737 F.3d 636 (9th Cir. 2013).

FACTS: Appellant, JEM Group, Inc. ("JEM"), a debt-relief company, implemented and managed debt-relief programs marketed by its affiliates. Through its affiliates, JEM entered into an agreement with Appellee, Rosita H. Smith ("Smith"), to provide debt settlement services. Smith signed a twenty one-page contract sent by one of JEM's affiliates. The contract contained a four-page attorney retainer agreement ("ARA"), written in fine print. The last page of the ARA contained an arbitration agreement, but there was no explanation of the agreement, only an instruction to sign at every 'X' and return the contract with a voided check.

Smith filed a breach of fiduciary duty claim against JEM and its affiliates, who moved to compel arbitration. The district court denied the motions to compel arbitration, and JEM appealed.

HOLDING: Affirmed.

REASONING: Under Washington law, a provision of an attorney fee agreement is unenforceable if the attorney does not comply with the Washington Rules of Professional Conduct. The Rules required an attorney to provide a reasonable and fair disclosure of material elements in any fee agreement. The court looked to an opinion of the Washington State Bar Association ("WSBA") requiring an arbitration provision to be consistent with a lawyer's fiduciary obligation and statutory law and be fully disclosed to the client. The court also noted that according to an ABA Formal Opinion, arbitration agreements are permissible in ARAs only if the client has been given sufficient information to make an informed decision about whether to agree to the inclusion of the arbitration provision in the retainer agreement.

For these reasons the appellate court affirmed the ruling that the arbitration clause was a material element of an ARA and unenforceable under Washington law, unless fully disclosed to the client.

NO FEDERAL PRESUMPTION OF ARBITRABILITY UNTIL COURT FINDS VALID ARBITRATION AGREEMENT

Dasher v. RBC Bank (USA) 745 F.3d 1111 (11th Cir. 2014).

FACTS: Appellant, Dasher, sued Appellee, RBC Bank ("RBC"), for excessive overdraft fees. Dasher's original agreement with RBC ("RBC Agreement") contained an arbitration clause that the district court found unenforceable. RBC appealed. While on appeal, the parties agreed to vacate and remand the district court decision for reconsideration.

While on remand, PNC Financial Services acquired RBC and took possession of Dasher's account. Thereafter, PNC issued a new agreement ("PNC Agreement") to Dasher, and Dasher accepted the agreement. The PNC Agreement did not contain an arbitration clause and stated that it superseded all prior agreements.

In light of the PNC Agreement, the district court concluded that the RBC Agreement was superseded, and thus, no arbitration agreement existed. RBC appealed.

HOLDING: Affirmed.

REASONING: RBC argued that the lower court improperly ignored the presumption in favor of arbitration under the Federal Arbitration Act. The appellate court found that the presumption in favor of arbitration applied only where a contract contained a valid and enforceable arbitration agreement. and was ambiguous as to whether it applied to the dispute in question. The court found that the presumption of arbitration does not apply in determining whether an agreement to arbitrate has been made.

The presumption in favor of arbitration applied only where a contract contained a valid and enforceable arbitration agreement.

In order for the appellate court to decide whether a valid arbitration agreement exists, the analysis turned on whether the PNC Agreement superseded the RBC Agreement. The court found the PNC Agreement superseded the RBC Agreement. Next, the court looked to whether the PNC Agreement contained a valid arbitration agreement. The court found there was no valid arbitration agreement because the PNC Agreement was completely silent on the issue of arbitration. Therefore, the court held RBC could not force arbitration.

AN ERRONEOUS REFERENCE TO THE LEGAL BASIS FOR ITS AWARD DOES NOT JUSTIFY OVERTURNING AN ARBITRATION PANEL'S AWARD OF ATTORNEYS' FEES

Adviser Dealer Servs., Inc. v. Icon Advisers, Inc.,____ F. App'x ____(10th Cir. 2014).

FACTS: Appellee, Icon Advisers, Inc. ("ICON"), parted ways with one of its senior executives, Stephen C. Holmes, who signed a retirement agreement upon his departure. Appellants, Adviser Dealer Services, Meeder Asset Management, Inc., and Meeder Financial, Inc. ("Meeder"), subsequently hired Holmes, in direct violation of a non-compete clause in his retirement agreement. After informal settlement talks failed, all three parties agreed to arbitrate their dispute pursuant to Financial Industry Regulatory Authority ("FINRA") rules. Each signed a Uniform Submission Agreement permitting a FINRA arbitration panel to award attorneys' fees to the prevailing party. Subsequently, the FINRA panel found Meeder jointly and severally liable, and awarded ICON damages that included attorneys' fees "pursuant to the retirement agreement" at issue, a statement likely made in error.

Meeder then filed a motion in district court to vacate the award of attorneys' fees on the basis of it not being a party to the original retirement agreement. The district court ruled in Meeder's favor. ICON appealed, and Meeder subsequently cross-appealed.

HOLDING: Reversed.

REASONING: The court held that each party was bound by

the terms of their FINRA Submission Agreements. The FINRA agreement granted the arbitration panel the express authority to determine all awards pursuant to a dispute, including attorneys' fees. The court noted that errors in an arbitration panel's factual findings, or its interpretation and application of the law, do not justify vacating an award. The court reasoned that even if the panel awarded attorneys' fees in error based on the terms of the retirement agreement, the court was not at liberty to overturn the panel's holding because all three parties had expressly delegated authority to award attorneys' fees to the panel in their FINRA agreements.

LANDLORD TENANT

PROPERTY CODE CANCELLATION AND RESCINDING OF CONTRACT REQUIRES BUYER TO RESTORE SELLER TO ORIGINAL POSITION

Morton v. Nguyen, 412 S.W.3d 506 (Tex. 2013).

FACTS: Petitioner, Morton, and Respondent, Nguyen, entered into a contract for deed. Pursuant to the Texas Property Code, Morton, as seller, continuously failed to provide Nguyen, as buyer, with required information in the annual statements. After thirty-four months, Nguyen sought to cancel and rescind the contract for deed. Additionally, Nguyen demanded restoration of all amounts paid under the contract and damages for breach of the Texas Property Code.

The trial court held for Nguyen, finding Morton did not comply with the Texas Property Code disclosure requirements and awarded Nguyen actual and liquidated damages. The appellate court reversed and remanded the trial court's judgment. Nguyen appealed.

HOLDING: Remanded.

REASONING: The Texas Supreme Court held that if the seller of a contract for deed fails to comply with disclosure requirements, Texas Property Code's Subchapter D requires the seller to cancel and *rescind* the contract for deed and give a *full refund* to the buyer.

The court, however, then addressed the definition of "rescission." Rescission is not a one-way street. Instead, it is a term that requires each party to restore property received from the other. To hold otherwise would create an unjust windfall to a rescinding buyer. The court defined "full refund" under Subchapter D. The court disagreed with the dissent's view that "full refund" was a unilateral refund. Instead, the court looked to the plain meaning of "refund," which is a transactional exchange where both parties give back what they previously received.

Applying this analysis, the court found that under a contract for deed transaction, the buyer cannot refund the title to the property because the buyer receives title only after all payments have been made. Instead the buyer must return what he received under the contract—the value of the occupation of the property. The Court remanded the case to the trial court for the determination of the value of Nguyen's occupation on the property.

LANDLORD WHO FAILS TO RETURN SECURITY DEPOSIT WITHIN STATUTORY TIME PERIOD MUST DEFEAT PRESUMPTION OF BAD FAITH

Johnson v. Waters at Elm Creek L.L.C., 416 S.W.3d 42 (Tex. App.—San Antonio 2013).

FACTS: Plaintiff, Shannon Johnson ("Johnson"), leased an apartment from and paid a security deposit to Defendant, Waters at Elm Creek ("Waters"). Waters was required to mail the security deposit refund and an itemized accounting of any deductions no later than 30 days after Johnson surrendered possession of the apartment.

Johnson surrendered possession of the apartment on October 5. Johnson received a check dated November 10 in the mail. The postmark on the envelope was dated November 11; however, the accounting was dated October 23. The trial court signed a take-nothing judgment in favor of Waters. Johnson appealed.

HOLDING: Reversed in part and affirmed in part.

REASONING: The court stated that under §92.109 of the Texas Property Code, a landlord is presumed to have acted in bad faith if she either fails to return a security deposit or fails to provide a written description and itemization of deductions on or before the 30th day after the date the tenant surrenders possession. Waters failed to do both of these things on or before the 30th day after the date Johnson surrendered possession.

The court noted that a landlord bears the burden to rebut the presumption of bad faith by presenting evidence that it acted in good faith. The court found good faith is established by showing honesty in fact in the conduct or transaction concerned. The court was provided testimony that showed the check was initially mailed to the address Johnson listed on her notice of intent to move out. The check was then returned to the corporate office of Waters. When Johnson called the property manager inquiring about the check, Johnson provided a new address and the check was re-sent. The court held that the property manager's testimony was sufficient evidence to rebut the presumption of bad faith.

The court found that under a contract for deed transaction, the buyer cannot refund the title to the property because the buyer receives title only after all payments have been made.

THE ONLY ISSUE IN A FORCIBLE ENTRY-DETAINER ACTION IS THE RIGHT TO POSSESSION

Williams v. Bayview-Realty Assocs., 420 S.W.3d 358 (Tex. App.—Houston [14th Dist.] 2014).

FACTS: Appellee, Bayview-Realty Associates ("Bayview"), initiated a forcible-detainer action against appellant, Marcus Williams ("Williams"), alleging that Williams violated a property rental agreement between the two parties and refused to vacate the premises. Bayview sought unpaid rent and a writ of possession.

The lower court rendered a final judgment in favor of Bayview in a bench trial. Williams appealed but failed to perfect the appeal, prompting Bayview to file a motion for default judgment. The county court granted Bayview's motion. Williams subsequently moved to set aside the default judgment and for a new trial. The county court denied his motions and signed an amended judgment. Williams appealed.

HOLDING: Affirmed.

REASONING: The court held that the sole issue in a forcible-detainer action under Texas law is the right to immediate and actual possession of a premise. A property owner does not need to produce proof of title, but instead needs to produce enough evidence of ownership to prove his superior right to immediate possession. Both a justice court and a county court at law have jurisdiction to hear forcible-detainer actions, but they do not have jurisdiction over title to land disputes.

MISCELLANEOUS

COMPANIES UNABLE TO REMOVE STATE-BROUGHT CONSUMER PROTECTION CASES TO FEDERAL COURT

Miss. ex rel. Hood v. AU Optronics Corp., 134 S.Ct. 736 (2014).

FACTS: Petitioner, State of Mississippi, filed a *parens patriae* suit against Respondent, AU Optronics, in state court, alleging that Optronics engaged in an illegal price-fixing scheme detrimental to numerous but unnamed state citizens. Optronics removed the case pursuant to the Class Action Fairness Act ("CAFA"), which lowers diversity jurisdiction requirements to allow removal of mass actions involving 100 or more persons.

The Court held that the CAFA requires mass action claims to be filed by 100 or more individually named plaintiffs seeking joint relief.

The district court held that the suit qualified as a mass action, but remanded it on grounds that it fell within the CAFA's "general public" exception. The Fifth Circuit reversed, concurring with the district court that the suit was a mass action, but finding the "general public" exception inapplicable. The Supreme Court granted certiorari.

HOLDING: Reversed and remanded.

REASONING: In a unanimous decision, the Court held that the CAFA's "100 or more persons" phrase, a prerequisite for removal, does not apply in cases where a state is the sole plaintiff and no individual persons are parties to the suit. While the CAFA substantially lowers barriers to filing mass actions in federal court, the Court held that the Act's plain language indicates that Congress did not intend for unnamed parties in interest to be included for numerosity purposes. Instead, the Court held that the CAFA requires mass action claims to be filed by 100 or more individually named plaintiffs seeking joint relief. Because the State of Mississippi was the sole named plaintiff in this suit, the Court remanded the case to state court.

DEFENDANT'S ATTORNEYS' FEE AWARD MUST SEGREGATE FEES

Goldman v. Olmstead, 414 S.W.3d 346 (Tex. App.—Dallas 2013).

FACTS: Appellee, Olmstead, entered into a contract to sell a home to Appellant, Goldman. After entering into the contract, Goldman gave written notice to terminate the contract.

Olmstead sued Goldman for breach of contract. In turn, Goldman sued his real estate agent and her associated broker, NRT Texas, L.L.C. (collectively "NRT"). NRT counterclaimed against Olmstead for fraud.

The court ruled in favor of Olmstead and awarded damages, costs, and attorneys' fees. The court also entered a take nothing against Goldman and awarded attorneys' fees to NRT. Goldman appealed the awards of attorneys' fees.

HOLDING: Remanded.

REASONING: On appeal, Goldman argued that NRT failed to segregate their attorneys' fees for the defense against Goldman and for the fraud counterclaim. The court held that a party seeking to recover attorneys' fees has the burden to show that the fees were reasonable and necessary and incurred on a claim that allowed recovery of such fees. Therefore, unless legal services advanced both recoverable and non-recoverable claims, the party must segregate recoverable fees and non-recoverable fees.

The court observed that NRT defended Goldman's claim and prosecuted a fraud claim against Olmstead. NRT's testifying expert on attorneys' fees did not segregate the fees between the defense of Goldman's claims and the prosecution of NRT's fraud claim. The expert also failed to testify the claims were so intertwined as to be inseparable. For this reason, the court remanded the determination of NRT's award of attorneys' fees to the lower court.

COURT FINDS TCPA CONSENT BASED ON TEN-YEAR OLD CONDUCT

Kolinek v. Walgreen Co., (N.D. Ill. 2014) (not designated for publication).

FACTS: Plaintiff Robert Kolinek ("Kolinek"), representing a putative class, sued Defendant Walgreen Co. ("Walgreens"), for violating the Telephone Consumer Protection Act of 1991 ("TCPA"). Around 2002, Kolinek provided Walgreens with his cell phone number for identification purposes. In 2012, Kolinek began receiving automated calls to refill his prescription. Kolinek claimed the calls were in violation of the TCPA because the calls were made using a prerecorded voice and without the recipient's consent.

Walgreens filed a motion to dismiss for failing to state a claim, asserting that Kolinek consented to the calls by providing his number in 2002.

HOLDING: Granted.

REASONING: The court noted that consent under the TCPA does not expire on its own; it must be revoked. The court stated that prior express consent under the TCPA was an affirmative defense on which the defendant had the burden of proof. However, the TCPA does not define prior express consent. Instead, Walgreens relied upon an interpretation of the defense by the Federal Communications Commission ("FCC").

Consent under the TCPA does not expire on its own; it must be revoked.

The court stated that the FCC's interpretation governed in this case, with the general rule stating that persons who knowingly released their phone numbers have in effect given their invitation or permission to be called at the number which they have given, absent instructions to the contrary. The court granted Walgreen's motion to dismiss, concluding that Kolinek failed to state a claim because the FCC's interpretation was binding on the court, and Kolinek admitted that he knowingly gave his cell phone number to Walgreens.

DISTRICT COURT FINDS NO TCPA VIOLATION FOR TEXT SENT BY SYSTEM LACKING PRESENT DIALING CAPACITY

Gragg v. Orange Cab Co.,____ F. Supp.2d ____(W.D. Wash. 2014).

FACTS: Defendant, Orange Cab Company ("Orange Cab"), used TaxiMagic, a computer program that linked Orange Cab's dispatch terminals with drivers. TaxiMagic sent a text message to customers after dispatch, in response to a driver's acceptance of a customer's request. Plaintiff, Torrey Gragg ("Gragg"), requested a taxi but did not provide his telephone number; however, Gragg's telephone number was captured through caller identification. As a result, he received TaxiMagic's message notifying him of the driver's acceptance.

Gragg filed suit alleging the text message violated the Telephone Consumer Protection Act ("TCPA"), specifically alleging that the TaxiMagic system was an Automatic Telephone Dialing System ("ATDS"). Orange Cab moved for partial summary judgment on the TCPA ATDS claim.

HOLDING: Granted.

REASONING: The court first identified what must be shown when alleging a violation under the TCPA: 1) Defendant must have called a cellular telephone number; and 2) Defendant was using an automatic telephone dialing system; 3) without the recipient's prior express consent. In order to be an ATDS, the equipment must either have had the capacity to store or produce the telephone numbers that are called using a random or sequential number generator, or be a predictive dialer with the capacity to dial telephone numbers from a lift without human intervention.

The court determined TaxiMagic's status under the TCPA was based on the system's present, not potential, capacity to store, produce, or call randomly or sequentially generated telephone numbers. The court stated that it would not adopt the broad interpretation of the term, thereby avoiding application of the TCPA violation to virtually limitless common technological devices. The court further explained TaxiMagic was not an ATDS because it did not have the capacity to randomly or sequentially generate telephone numbers to be stored, produced, or called. The system utilized telephone numbers provided directly by customers or captured using Caller ID.

The court also found that TaxiMagic was not a predictive dialer because of the human intervention that was required to send Gragg a text message. For the text message notification to be sent to the customer, the customer must have first provided information to the dispatcher, the dispatcher must then have transmitted the information, and the driver must have accepted the information on the data terminal. The level of human agency involved was sufficient to be "human intervention."

THE LAST WORD

As you may have notice, this is a smaller issue than usual. Unfortunately, several articles were not quite ready for publication, but we wanted to get this issue out so that the updates and alerts would be timely. Looks like the next issue will be substantially larger.

This issue, however, does include an interesting discussion of "Too Big To Fail." The Federalist Society is not a regular contributor to the *Journal*, but the discussion from its National Lawyers Convention proves to be interesting reading. While you may not agree with some of the politics, I think you will enjoy reading the article.

Finally, as usual, the "Recent Developments" section includes brief discussions of the most significant consumer law decisions reported during the past few months. If your practice includes consumer law, the *Journal* continues to be the best way to stay current.

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Editor-in-Chief

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