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## Federal Reserve Issues Final Telecheck Rule

*By: Keith A. Gauer*

On November 28, 2005, the Board of Governors of the Federal Reserve System announced a new final rule amending the provisions of Regulation CC. The amendments, which become effective on July 1, 2006, establish new transfer and presentment warranties for "remotely created checks." Remotely created checks (also known as telechecks, preauthorized checks, or demand drafts) are checks created when the holder of a checking account authorizes a payee to draw a check on that account but does not actually sign the check. Instead, the drawer authorizes a third party to create the check through the third party's computer system by providing the account information from the bottom of a check. Remotely created drafts are frequently used by creditors to expedite collection efforts. In many situations, remotely created checks are an appropriate and useful tool to facilitate

payments. However, when a customer's account information ends up in the hands of a fraudster, remotely created drafts have facilitated fraudulent schemes to inappropriately withdraw money from customer accounts.

Under current law, the Uniform Commercial Code mandates that a payor bank (the bank on which the check is written) may only honor checks that are properly payable. A check is not properly payable if the drawer did not sign the check or authorize a third party to sign the same. In the normal course of check processing, however, the midnight deadline mandates that the payor bank must return a check that is not properly payable by midnight of the day after the check is presented. With the advent of automated check processing, few banks check signatures

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## Collection Efforts Following the Filing of a Form 1099-C Information Return

*By: Amy M. Ross*

A financial institution that writes off or discharges a customer's debt of \$600 or more during any one calendar year must report the transaction by filing a Form 1099-C information return with the Internal Revenue Service ("IRS"). Notwithstanding some exceptions, the customer will then be required to report the cancelled debt as income on the

customer's next federal income tax return. The financial institution may be entitled to a corresponding bad debt deduction on its next federal income tax return. If the customer's financial situation subsequently improves to such an extent that the customer is able to repay the debt, may the financial institution accept voluntary

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upon customer checks and, even those that do, only examine checks written for sums in excess of a threshold amount such as \$50,000. As such, the vast majority of checks are not reviewed by bank employees at all. As a result, in the case of a remotely created draft, a bank may only receive notice that a remotely created draft was not signed or authorized by its customer when the customer reports the error following receipt of the customer's monthly statement. At that point in time, however, it is too late for the bank to pass the loss "upstream" to the presenting and depository banks.

The revisions to Regulation CC change the rules of check processing as they relate to remotely created drafts. Under the revisions, a bank that transfers or presents a remotely created draft and receives payment therefor, warrants that the person on whose account the check is drawn authorized the issuance of the check in the amount stated on the check and to the payee identified on the instrument. As such, if a payor bank receives notice from its customer that a remotely created draft honored on the customer's account was not properly authorized, the payor bank can now pass this loss upstream in the check collection process. Ultimately, the revisions to Regulation CC place the risk that the remotely created draft was not authorized by the customer on the depository bank or the first bank receiving the item for processing and payment.

Many South Dakota banks and bank servicers participate in the issuance and servicing of credit card, payday loan, and other payment processing and collection services. Many of these creditor-related activities utilize remotely created drafts to facilitate the payment process. The revisions to Regulation CC increase the risk to depository banks involved in processing remotely created drafts generated by a bank's customer. Any bank having customers who utilize remotely created drafts will want to amend its customer account agreements to either prohibit the practice or at least to alter the risk of loss in connection with an unauthorized remotely created draft deposited by the customer. Most likely, the customer account agreement should be amended to

require the depositor to indemnify the bank from any warranty claims made by third parties as a result of allegedly unauthorized remotely created drafts. Further, entities utilizing remotely created drafts should be required to retain evidence of the authorizations. Evidence that the customer authorized the creation of the remotely created check (usually proven through a voice recording) can form a defense to a warranty claim. DEHS

## Collection Efforts Following the Filing of a Form 1099-C Information Return

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payments from the customer? If no payment is volunteered, may the financial institution reinstitute its collection efforts with respect to this debt? The focus of this article will be on these two questions.

Solely for purposes of the Form 1099-C reporting requirement, a discharge of indebtedness is deemed to have occurred upon the happening of any one of the following “identifiable events”:

- (A) A discharge of indebtedness in bankruptcy;
- (B) A cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness;
- (C) A cancellation or extinguishment of an indebtedness pursuant to an election of foreclosure remedies by a creditor that statutorily extinguishes or bars the creditor’s right to pursue collection of the indebtedness;
- (D) A cancellation or extinguishment of an indebtedness that renders a debt unenforceable pursuant to a probate or similar proceeding;
- (E) A discharge of indebtedness pursuant to an agreement between the creditor and a customer to discharge indebtedness at less than full consideration;
- (F) A discharge of indebtedness pursuant to a decision by the creditor, or the application of a defined policy of the creditor, to discontinue collection activity and discharge the debt; or
- (G) A discharge upon the expiration of a nonpayment testing period for accounting purposes.

See 26 C.F.R. § 1.6050P-1.

Several of the identifying events recited above would legally discharge the debt and thereby extinguish the financial institution’s right to enforce the customer’s obligation. Even where the identifiable event falls short of a legal discharge of the indebtedness, the case law appears to suggest that the filing of a 1099-C prohibits a financial institution from continuing to collect on the debt unless the 1099-C is subsequently corrected or withdrawn to indicate to the IRS that the form was mistakenly filed. See *In re Crosby*, 261 B.R. 470 (Bankr. D. Kan. 2001). In the *Crosby* case,

the United States Bankruptcy Court for the District of Kansas held that the actual, or at least potential, tax consequences of a financial institution filing a Form 1099-C make it inequitable to allow the institution to enforce its claim against the debtor, unless the institution corrected or withdrew its mistakenly-filed Form 1099-C.

While the discharge may affect the financial institution’s right to collect from the customer, the case law does not appear to suggest that the financial institution is precluded from accepting a subsequent payment made voluntarily by the customer. In cases where the discharged debt is subsequently paid voluntarily, the recovery of bad debt deducted by a financial institution in an earlier tax year is includable by such institution as income for the current tax year unless the previous deduction did not result in any tax savings for the institution. If the bad debt deduction and 1099-C reporting was accomplished in a previous tax year, the federal regulations state that no additional reporting or Form 1099-C correction is required. However, if the financial institution files a Form 1099-C information return with the IRS and subsequently receives payment from the customer in the same tax year, the financial institution would then need to correct or cancel the Form 1099-C by filing a Form 1096 with the IRS. DEHS

## Sweep Arrangements

By: Kristina M. Schaefer

As financial institutions examine ways to attract and maintain customers, one popular arrangement often considered is the use of “sweep accounts.” Generally speaking, sweep accounts allow customers historically ineligible for interest-bearing accounts to invest excess funds from their commercial demand deposit accounts (DDAs) into another type of account that provides earnings. In other words, this allows customers to receive payment of compensation (i.e., interest) on excess deposits.

The implementation of a successful sweep program allows customers to continue to write checks and make deposits from their DDAs, but also allows customers to earn money when their DDA balance exceeds a “target balance.” When the balance exceeds the target balance, the excess funds are “swept” into a separate account. If the balance falls below the target balance, then funds are “swept” from the interest bearing account to the DDA in order to pay the checks.

Sweep arrangements may be structured in a variety of different ways with different legal and regulatory considerations. One popular arrangement is an “in-house” approach utilizing repurchase agreements, commonly referred to as “repos.” In a typical repo arrangement, excess funds are swept out of the DDA at the end of each day, invested in repos and returned the next business day with interest.

Repos are secured by government securities owned by the financial institution which are direct obligations of, or are guaranteed as to principal and interest by, the United States or one of its agencies. To avoid violations of Regulation D and federal securities laws, a financial institution must ensure that the type of security is, in fact, fully guaranteed by the United States government or one of its agencies. For example, bills, notes and bonds that are direct obligations of the United States government would be eligible for repo transactions; municipal securities, however, would not be eligible. Financial institutions must be exceptionally diligent to determine whether the debt instrument is actually guaranteed by an agency of the United States government. For example, securities issued by the Tennessee Valley Authority (TVA) are not guaranteed by the United States government, although the TVA is a government corporation. Ginnie Mae guaranteed securities, however, are

fully backed by the United States government. Moreover, the securities of government sponsored enterprises (or GSEs) are generally not obligations of, nor are they guaranteed by, the United States government.

In addition to the restriction on the type of securities which may be utilized in repo arrangements, the Government Securities Act of 1986 (GSA) imposes several additional restrictions on the use of these arrangements, including detailed confirmation and disclosure requirements. For example, in sweep account repos in which a new repurchase transaction occurs daily, the financial institution must provide a daily confirmation notice. In addition, it is permissible for a particular customer to hold a fractional interest in an underlying security so long as the transaction is tied to a specific security, instead of a pool of securities, and the total fractional interest sold by the institution to customers does not exceed 100 percent of the security; however, the confirmation notice must specify the fractional interest held by the customer in the security. Additionally, should the financial institution have the right to substitute securities for others under the sweep agreement, the regulations require the disclosure of additional information regarding such substitution in the agreement.

While utilizing repurchase agreements is certainly a popular option for many financial institutions, there are a variety of other methods for implementing a successful sweep program. For example, a financial institution may choose to sweep funds from a savings account into a demand account or from a demand account to a mutual fund controlled by the bank.

Despite the fact that sweep arrangements are a popular way for banks to attract new customers and maintain existing customers, there are certain risks and compliance considerations involved in such a product. For example, repos are not deposits of financial institutions and not covered by FDIC insurance. In addition, if the sweep arrangement is linked to a savings account, there will be Regulation D implications. As a result, financial institutions must carefully evaluate any contemplated sweep arrangement and ensure that it complies with all applicable laws and regulations. DEHS

## Authentication in an Internet Banking Environment

By: Kristina M. Schaefer

On October 12, 2005, the Federal Financial Institutions Examination Council (FFIEC) released updated guidance focusing on the risks and risk management controls necessary to authenticate the identity of customers accessing Internet-based financial services. This guidance replaced the guidance issued in 2001 on this topic due to the changes in the technological and legal landscape, such as increased incidents of Internet-based fraud and identity theft. The guidance applies to transactions involving both retail and commercial customers, as well as telephone banking transactions that may be considered “high-risk.”

The majority of the guidance is devoted to ensuring that financial institutions appropriately authenticate the identity of their customers. “Authentication” is the process of verifying the identity of a person in order to control access to customer accounts and personal information. Authentication factors typically include something a person knows (a password), something a person has (a physical device, such as a token) or something a person is (physical characteristics, such as fingerprints).

Typically, financial institutions authenticate a customer’s identity in electronic transactions by requiring the customer to enter a correct password (something the customer knows). However, the new guidance provides that single-factor authentication, such as the use of a password, as the only control mechanism will be inadequate for “high-risk transactions,” such as those involving access to customer information or the transfer of funds. As a result, financial institutions may need to reconsider the technology currently used to authenticate their customers for certain high-risk electronic transactions and consider the implementation of multi-factor authentication and layered security. An example of multi-factor authentication would include the verification of a customer’s identity by the customer entering a personal password (something the customer knows) and the password from a password-generating token (something the customer has). Layered security is the combination of several different

security components, such as antivirus software, firewalls, intrusion detection systems, and vulnerability assessment tools.

Authentication methodologies are numerous and vary considerably in their complexity and cost. Financial institutions will want to work closely with their legal counsel, compliance personnel, and technology department to consider the benefits and disadvantages of certain methods of authentication, such as shared secrets, USB token devices, digital certificates, and biometrics.

The guidance also discusses the importance of a thorough risk assessment and the development of adequate security standards and policies. The risk assessment process should, at a minimum, (1) identify all transactions and levels of access associated with Internet-based customer products and services; (2) identify and assess risk mitigation techniques; and (3) include the ability to gauge the effectiveness of the risk mitigation techniques. The guidance also discusses the importance of using reliable methods to verify the identity of customers, particularly when originating new customer accounts online. In addition, the guidance encourages financial institutions to make efforts to educate their customers on the importance of Internet security and the risks associated with Internet transactions. Finally, the guidance addresses the importance of adequate monitoring and reporting systems for electronic systems.

Financial institutions are expected to comply with the new guidance by year-end 2006 and therefore should begin steps to ensure compliance with the new guidance as soon as possible. DEHS

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Davenport, Evans, Hurwitz & Smith, LLP was founded in 1939. Since that time, the firm has grown steadily and is now one of the largest firms in South Dakota. One of the firm’s primary practice areas is the Banking and Financial Services Group. The firm acts as counsel to many South Dakota banks, financial institutions, holding companies, and service providers. Davenport, Evans was recently recognized in the Chambers USA 2004 client guide as a “leading firm of choice in South Dakota creditor circles” and as a “long established player...recognized for its preeminent banking” practice and its “superlative banking and securities law expertise.”

The firm handles all aspects of banking law, from entity formation, acquisitions, and branching, to operational issues involving lending, compliance, creditors' rights, payment processing (check, ACH, wire transfer), general commercial law, and trust administration. The firm represents banks in all phases of state and federal banking regulation and deals extensively with state and federal banking regulators. The firm understands that keeping up with new regulatory developments is a major challenge for banks today and helps its clients respond to that challenge effectively and efficiently.

South Dakota has become a major center for financial services, with approximately a half dozen credit card processing centers located in the Sioux Falls area alone. The firm has served as counsel to many of these entities and has particular experience and expertise in the areas of credit card issuance, compliance, and receivables securitization.

The firm also represents its bank clients in bankruptcy matters and complex commercial litigation on a regular basis. Davenport, Evans often acts as counsel to lenders in loan workouts and bankruptcy cases filed in South Dakota. The firm’s Banking and Financial Services Group, together with the firm’s strong Litigation Group, also handles commercial litigation such as bank shareholder disputes, complex lender liability cases, bank marketer disputes, federal compliance cases, and many other litigation issues.

Numerous out-of-state and nationwide lenders also retain the firm for review of loan documents, compliance with state and federal law, and assistance in completing major real estate and commercial loans. The firm also assists out of state individuals and entities in the formation and operation of trust companies.

If you have any questions regarding the firm's Banking and Financial Services Group, please feel free to contact us at your convenience.

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