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Check 21: How Will it Impact Your Bank?

By: Keith A. Gauer

The Check Clearing for the 21st Century Act ("Check 21") becomes effective on October 28, 2004. Congress passed the Act to facilitate and improve the overall efficiency of the check collection process by, in part, authorizing the use of electronic images in the course of check collection and payment. But, how will Check 21 affect your bank in South Dakota? Will you be forced to purchase new expensive hardware or software to continue your normal check collection processes?

Generally speaking, Check 21 does not require banks to utilize new computer imaging technologies in the course of processing checks. Check 21 does, however, introduce the legal concept of a "Substitute Check." A Substitute Check is a paper reproduction of an original check which includes:

- (1) an image of the front and back of the check,
- (2) bearing a MICR line with all information from the original check,
- (3) conforming in paper stock to industry standards, and
- (4) suitable for automated check processing.

Check 21 facilitates the check collection process by mandating that banks accept a Substitute Check in place of the original check. If a bank agrees with its correspondent bank or banks to forward or receive checks electronically, the transmission will include an electronic image of the Substitute Check. No bank, however, is required to transmit or receive checks electronically under Check 21. A bank must, however, accept a paper copy of the Substitute Check if it is presented for payment. No bank will have a right to

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The Servicemembers Civil Relief Act of 2003

By: Amy M. Ross

Purpose of the Act

The Servicemembers Civil Relief Act of 2003 became effective on December 19, 2003, and applies to any civil case that is not final before that date (hereinafter referred to as the "Act" or "SCRA"). The Act completely rewrites the Soldiers' and

Sailors' Civil Relief Act of 1940 ("SSCRA") by expanding many of the previous Act's civil protections. The SCRA imposes substantial restrictions on the ability of a creditor to collect on debts of military personnel. The SCRA is designed to give servicemembers relief from obligations and

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Check 21: How Will it Impact Your Bank? (cont.)

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demand presentment of the original check. As noted above, Check 21's provisions require the Substitute Check to be in a form suitable for automated processing. As such, banks should be able to use their standard check processing equipment even after Check 21 becomes effective.

Once Check 21 becomes effective, banks desiring to expedite the check collection process or save the expenses of having physical checks transferred through the system will likely enter into agreements with their correspondent banks allowing for the electronic transfer of checks in the collection process. Once such an agreement is in place, a check can be presented or transferred electronically by sending the Substitute Check in electronic form to the upstream bank.

A bank creating a Substitute Check (known as the "Reconverting Bank" under the Act) makes certain warranties to other subsequent banks in the check collection process. These warranties include a commitment that the check accurately represents the original, including all endorsements. Further, the Substitute Check must identify the bank converting the original check. Finally, and perhaps most importantly, the Reconverting Bank warrants to other downstream banks that no party will be asked to make payment based on a check that has already been paid. In other words, the drawer's bank should never be placed in a position of being asked to honor both a Substitute Check and the original check. In general, the warranty provisions are designed to place the risk and burdens upon the Reconverting Bank who created the Substitute Check.

A Substitute Check created under Check 21 is the legal equivalent of the original check. Any bank that still returns original checks to its customers on a monthly basis will now return a Substitute Check if presentment is accomplished by way of the Substitute Check. Banks will likely need to educate their customers (and perhaps revise their account agreements) so that the customers understand that the Substitute Check is the legal equivalent of the original instrument. If a bank sends an "image statement" to its customers, the image

produced will simply be a picture of the Substitute Check.

In summary, once Check 21 becomes effective, all banks in South Dakota will likely encounter Substitute Checks in the course of their normal checking account operations. Banks will not be required to acquire and employ new technology in the course of their checking operations. Banks may, however, want to consider acquiring technology and amending agreements with their correspondent banks should they desire to expedite the check collection process or save costs encountered in forwarding checks manually. DEHS

The Servicemembers Civil Relief Act of 2003 (cont.)

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liabilities they may have entered into prior to entering active military service. This article will focus on those provisions of the Act that are most likely to impact the collection activities of financial institutions.

Who is protected by the Act?

The Act's protection applies to servicemembers (including reservists) of the Army, the Navy, the Air Force, the Marine Corps, the Coast Guard, the National Guard, and all commissioned officers of the Public Health Service or the National Oceanic and Atmospheric Administration.

SCRA calls for the temporary suspension of judicial and administrative proceedings during a servicemember's active duty and also during those periods where training or education as a preliminary to induction into military service is received and periods where training or education as a preliminary to induction into military service is received and periods when the servicemember is absent from active duty on account of sickness, wounds, leave, or other lawful cause (hereinafter collectively referred to as "active military service").

The benefits of the Act have also been extended to the dependents of servicemembers and to sureties, guarantors, endorsers, accommodation makers, co-makers, or other persons who are or may be primarily or secondarily subject to a servicemember's obligation or liability.

Active Military Service Must "Materially Affect" Ability to Pay

In order for the servicemember to exercise his or her rights under the SCRA, several provisions require the servicemember to prove that his or her active military service has materially affected the particular situation. Other sections of the SCRA put the burden on the party opposing the servicemember's assertion of rights under the SCRA to prove that the situation is not materially affected by the servicemember entering active military service.

Key Provisions of the Act

- **Repossession:** A servicemember is protected from repossession of personal property that serves as security for pre-service debts incurred under installment sale contracts and lease/purchase contracts. The Act prohibits a creditor from terminating the contract or lease and/or repossessing the property for nonpayment or breach occurring before or during active military service without a court order. Further, the Act does not apply where the servicemember has become obligated under an installment contract after entering active military service. Any person who knowingly repossesses (or attempts to repossess) property which is covered by the Act can be fined or imprisoned for not more than one year, or both.
- **Suspension of Payments and Extension of Repayment Period:** A court may suspend the servicemember's obligations to make payments during the period of active military service and extend the term of the servicemember's installment contract by a period equal to the length of time spent in active military service or any part of such period as the court may determine. This stay is to be subject to the servicemember's payment of the balance of principal and accumulated interest due and unpaid at the date of his or her termination or release from active military service. The creditor is not permitted to impose any fine or penalty for failure to comply with the original obligation so long as the servicemember complies with the terms and conditions of the stay.
- **Default Judgments:** Before entering default judgment on behalf of the plaintiff, the plaintiff must file an affidavit stating whether the defendant is engaged in military service. If the defendant is engaged in military service, the court must appoint an attorney to represent the defendant before default judgment is entered against the servicemember.

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The Servicemembers Civil Relief Act of 2003 (cont.)

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- ***Stay on Judicial Proceedings and Execution of Judgments:*** While not prohibited, a creditor's ability to initiate judicial proceedings and execute judgments to collect amounts owed it is severely limited by the Act. The SCRA applies to any civil judicial or administrative proceeding commenced in any court. At any stage before final judgment in any civil action or proceeding in which a servicemember is a party, during the period of such service or within 90 days after termination of or release from military service, a court may on its own motion and shall, upon the servicemember's request, stay the action or proceeding for a period of not less than 90 days if the servicemember submits 1) a letter or other communication setting forth facts stating the manner in which current military duty requirements materially affect the servicemember's ability to appear and stating a date when the servicemember will be available to appear, and 2) a letter or other communication from the servicemember's commanding officer stating that the servicemember's current military duty prevents appearance and that military leave is not authorized for the servicemember at the time of the letter. If a servicemember, in the opinion of the court, is materially affected by reason of active military service in complying with a court judgment or order, the court may also on its own motion and shall, upon the servicemember's application, stay the execution of any judgment or order entered against the servicemember.
- ***Limitations on Revocation of Credit and Adverse Credit Reporting:*** A creditor may not, simply because a servicemember has requested the benefits available under the Act, determine that the servicemember is unable to pay, deny or revoke credit or change the terms of an existing credit on the terms requested, submit an adverse credit report to a credit bureau, or denote the fact that the debtor is a servicemember.
- ***Limitation on Interest Rates:*** In addition to limiting repossession, suspending payments, and extending the repayment period, the Act provides that the interest rates on a servicemember's contractual obligations incurred prior to entry into active military service be capped at six percent for the duration of the servicemember's military service. To receive the interest rate reduction, the servicemember must provide the creditor with written notice and a copy of orders calling the servicemember to active military service. The servicemember is not required to prove that his or her active military service materially affected his or her ability to make payment on the obligation. Once such notice has been provided to the creditor, the six percent interest rate cap should be retroactively applied to the date the servicemember entered active military service. The reduction in the interest rate applies only as long as the servicemember is engaged in active military service. After the service member is released from such military service, the creditor cannot increase the interest rate or charge the servicemember any fees in order to make up for the decreased income that occurred when the interest rate was reduced. Nor can the creditor require the servicemember to pay extra principal on an obligation while the servicemember is engaged in active military service in order to make up for the lost interest.
- ***Extension of Statutes of Limitations:*** The SCRA tolls statutes of limitations for bringing any action or proceeding by or against a servicemember or against the servicemember's heirs, executors, administrators or assigns during the period the servicemember is engaged in active military service. Once the servicemember shows he or she is engaged in active military service, the period of limitations is tolled automatically until the servicemember is released from such military service.

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The Servicemembers Civil Relief Act of 2003 (cont.)

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A creditor, by judicial action, may seek a court order that a servicemember's ability to pay interest at a rate in excess of six percent per year is not materially affected by reason of his or her entering active military service. Additionally, any obligations incurred after the servicemember enters active military service are not subject to the six percent ceiling.

"[T]he Act provides that the interest rate on a servicemember's contracted obligations...be capped at six percent..."

Collection Activity

While not detailed in the Act, the foregoing restrictions suggest that collection activity should be limited and very conservative during the period in which the servicemember is in military service. A creditor may consider not pursuing any collection activity during the period that the servicemember is in military service, instead only sending billing statements and imposing interest to the extent permitted under the contract, as limited by the provisions of the Act. This approach is based on the fact that the creditor could not repossess collateral under an installment contract or lease without court action, and if the creditor were to institute a court proceeding to enforce payment by the servicemember or authorize a repossession, the servicemember could request that the court stay the enforcement of the obligation for an extended period as outlined in the Act. To the extent a creditor does wish to pursue collection activities during the period the servicemember is in military service, the safest course for doing so would be to institute a court proceeding, since the court may determine that the servicemember was not materially affected by his or her entry into active military service and is therefore not entitled to protection under the Act.

Notification by Servicemembers

To receive the various benefits of the Act, a servicemember must notify the creditor of the servicemem-

ber's entry into active military service. With the exception of the interest rate reduction, the Act does not specifically require notification of the creditor by the servicemember, but the Act also does not impose any affirmative duty on a creditor to ascertain a debtor's status as a servicemember. Because there is no way for the creditor to know of the servicemember's entry into active military service unless the servicemember so notifies the creditor, a reasonable interpretation of the Act would be to require such notification.

Waiver of Rights by a Servicemember

A servicemember may waive the rights and protections provided by the Act by a separate writing executed during or after the servicemember's period of military service. If the servicemember is not a party to the writing, the writing must also state the name of the servicemember concerned. A creditor cannot force the servicemember to enter into such an agreement, nor can a servicemember's rights be waived prior to entering active military service.

Anticipatory Relief

A servicemember may apply for relief from any obligation or liability incurred by the servicemember prior to entering active military service, while engaged in active military service or within 180 days of release from such military service. The obligation does not need to be in default for the servicemember to apply for relief. DEHS

New South Dakota Laws and Amendments Affecting Lending and Financial Institutions

By: Charles D. Gullickson and Matthew W. McNamee

In the 2004 session, the South Dakota legislature enacted several laws which may be of interest to financial institutions and lenders. Except as otherwise indicated, all of the referenced new laws and amendments become effective on July 1, 2004.

Amendment to Statute Concerning Lending License Exemptions

The legislature adopted House Bill 1043 which amends exemptions found in SDCL ch. 54-4-37 concerning the lender licensing requirements found in SDCL ch. 54-4. As amended, the statute exempts state and national banks, bank holding companies, and other federally insured financial institutions, as well as their respective holding company and subsidiaries, and South Dakota chartered trust companies from the lender licensing requirements. The bill also amends SDCL ch. 54-14-4 to exempt such entities, along with South Dakota licensed real estate brokers and certain insurance companies participating in mortgage lending activities, from the chapter governing

the mortgage lender business.

Amendment to Statute Relating to Payday Loans

The legislature adopted House Bill 1049, which amended the money lending license statute to add the definition of “payday loan” as a “small, short-maturity loan on the security of a check, any assignment of an interest in the account of a person at a depository institution, any authorization to debit the person’s deposit account, or any assignment of salary or wages payable to a person.” The bill also replaces the term “deferred presentment service transaction” with the term “payday loan” in SDCL ch. 54-4-65, which restricts the number of renewals of such loans to four, and requires the borrower to pay the outstanding fee at the time of renewal, and in SDCL ch. 54-4-66, which limits the maximum amount of such a loan to \$500.

Authorization for Banks to be Organized as LLCs

House Bill 1123 permits banks to be organized as limited
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Perfection of Security Interest in Used Car Inventory

By: Robert E. Hayes

Consider the following hypothetical loan:

Very Careful National Bank (“VCNB”) and its diligent loan officer, Paul Persnickety, make a loan to E.Z. Credit d/b/a Easy Credit Cars (“E.Z. Credit”). The loan is secured by a Security Agreement granting VCNB a blanket security interest in E.Z. Credit’s personal property, including his inventory of used cars. Paul Persnickety, having previously lost a vehicle to a bankruptcy trustee where he failed to note a lien upon the certificate of title for the vehicle securing a personal loan to a customer, carefully took possession of all of the titles to E.Z. Credit’s inventory and proceeded to process the paperwork to have VCNB noted as a first lienholder on the titles for each of the vehicles. Unfortunately for E.Z. Credit, the new car manufacturers began to again offer zero percent financing on all new cars and E.Z. Credit’s business goes in the tank. Subsequently, E.Z. Credit files a Chapter 7 bankruptcy proceeding. Paul Persnickety is, however, confident that his security interest in E.Z. Credit’s inventory will prevail and he will be able to take possession of and liquidate the motor vehicle inventory in satisfaction of his claim. Is he right? No.

A security interest in motor vehicles held in inventory is perfected only by filing a financing statement with the Secretary of

State. A creditor may not perfect its security interest by maintaining possession of the titles themselves or by noting its name on the certificates of titles where the vehicles are held in inventory for re-sale. The bankruptcy trustee’s avoidance powers under the Bankruptcy Code will prevail and the property will likely be turned over to the estate and sold for the benefit of the unsecured creditors. If, of course, Paul Persnickety were to perform a compliance review and discover the error in failing to file a financing statement before the bankruptcy, he would be free to immediately file a financing statement to perfect the interest at a later date (subject to potential preference issues if the financial statement is filed within ninety (90) days of the bankruptcy). VCNB would not need to obtain E.Z. Credit’s consent as his grant of a security interest to VCNB in the Security Agreement is considered to be an implied consent to the filing of a financing statement under Revised Article 9. DEHS

New South Dakota Laws and Amendments Affecting Lending and Financial Institutions (cont.)

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liability companies and makes corresponding additions and changes to several statutes discussing bank formation structure. The bill also makes some minor wording changes to SDCL ch. 51A-5-6, relating to the ability of national banks to engage in trust business.

Inclusion of Certain Trust Accounts for Pay on Death Designations

House Bill 1130 amends the Uniform Probate Code as enacted in South Dakota (SDCL ch. 29A-6-301(5)) by expanding the definition of "security account" for purposes of transfer on death or pay on death designations to include investment management or custody accounts with a trust company or trust division of a bank.

Authorization for Investment of Public Funds in CDs Insured by FDIC

House Bill 1137 enacts a new section which permits the investment of public funds not needed for current operating expenses in certificates of deposit which are insured by the Federal Deposit Insurance Corporation. Such funds may be deposited with a South Dakota bank or savings and loan association which offers FDIC insurance on its deposits, and that bank or savings and loan association may then arrange for the deposit of the public money in CDs in one or more other banks or savings and loan associations within the United States, which CDs are insured by the FDIC.

Increase of Certain Fees Charged by Division of Banking

House Bill 1144 amends the fees charged by the Division of Banking to increase the maximum original and renewal license fees for money lenders from two hundred and fifty dollars to one thousand dollars, caps the original license and renewal fees for mortgage bankers at one thousand dollars and for mortgage brokers at five hundred dollars, increases the maximum fee charged to money order business licensees from two hundred and fifty dollars to one thousand dollars, and clarifies that the license fee must be paid by June 15 for a July 1 renewal. This bill was effective as of February 26, 2004.

Limitation of Lender Environmental Liability under Brownfields Program

House Bill 1157 amends South Dakota's environmental protection statutes by exempting lender-owners from liability for environmental, response, cleanup, or remediation costs at brownfield sites approved by the state Department of Environment and Natural Resources, unless the lender-owner (i) directly causes or exacerbates a release of regulated substances or directly violates an environmental statute or regulation; or (ii) compels the borrower to cause the release or violate any environmental statute or regulation.

Revision of Statutes Governing Trusts

Senate Bill 99 clarifies the powers of the Director of the Division of Banking and the State Banking Commission with respect to trust companies, and their ability to use confidential information in connection with their exercise of such powers. Under the bill, South Dakota and its courts have jurisdiction over foreign trusts meeting the statutory criteria established for domestic trusts. Also, the bill establishes other parties to whom certain notices and from whom certain consents may be sought in the case of persons under a disability. In addition to the power of a trustee or beneficiary to petition a court to supervise a trust, such parties may now petition the court to end its supervision of a trust. In the case of the combination of multiple trusts, or the division of one trust into multiple trusts, and on motion of a trustee or beneficiary, the court is now required to resolve inconsistencies between trust instruments. The bill also amends current law to allow a trustee to terminate a noncharitable trust if the value of the trust property is less than fifty thousand dollars.

* * *

Please recognize that the above summaries are meant for general reference only, and a more thorough analysis of the statutory provisions may be required to assess their impact on your organization. The complete text of the bills referenced above can be found at <http://legis.state.sd.us/sessions/2004/billsign.htm>. 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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