Winter 2023

Financial newsletter

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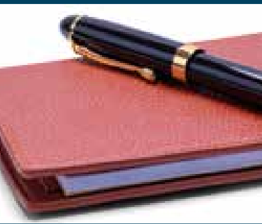

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HOW TO AVOID CONVERSION CLAIMS WITH JOINTLY PAYABLE CHECKS

This article is intended to be a "refresher" on how lenders can avoid conversion claims in connection with certain jointly payable negotiable instruments. Certain types of negotiable instruments (e.g., jointly payable checks) can benefit lenders, as demonstrated in the hypothetical below, but these instruments can also cause a lender problems if these instruments are not properly endorsed and negotiated.

For example, if a lender finances a debtor's farming operation, that lender may sometimes file an Effective Financing (EFS)/Statutory Lien Notice (CNS-1) form[1] to get the lender's name put on checks from the sale(s) of a debtor's commodities that the debtor sells on the open market. That way, when the debtor sells its livestock or crops to a third party, the third party will make any check(s) for the purchase of the debtor's livestock or crops payable to "Debtor *and* Lender."

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[1] This option is available in Minnesota and other states that have adopted the Central Notification System.

HOW TO AVOID CONVERSION CLAIMS WITH JOINTLY PAYABLE CHECKS

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This common arrangement ensures that the proceeds from the sale of the debtor's commodities will be shared with the lender because the lender's endorsement on these jointly payable checks is required for the jointly payable checks to be lawfully negotiated and deposited into an account or cashed.

However, there has been some recent litigation involving the conversion of checks arising from situations where checks have been issued jointly payable to "Debtor *and* Lender," but *only* the Debtor endorses the checks and thereafter attempts to negotiate and deposit the checks without the Lender's endorsement. If the jointly payable checks are negotiated and deposited without *both* of the required endorsements, litigation is likely to arise, and the law is clear that the co-payee on the check who did not endorse the jointly payable check will have conversion claims against both the "payor / drawee" bank (i.e., the bank ordered in the draft to make the payment) and the "depository" bank (i.e., the bank where the jointly payable check is deposited into).

Article 3 of the Uniform Commercial Code applies to the above hypothetical. Specifically, Article 3 expressly provides that "[i]f an instrument is payable to two or more persons *not alternatively*, it is payable to all of them and may be negotiated, discharged, or enforced *only* by all of them." Minn. Stat. § 336.3-110(d) (emphasis added). The above-quoted statutory language means that a check made jointly payable to two payees may not be negotiated for deposit by only one of the payees alone. This conclusion is further emphasized in the "comments" made by the drafters of Article 3 of the Uniform Commercial Code, which provide that:

> If an instrument is payable to X and Y, neither X nor Y acting alone is the person to whom the instrument is

payable. Neither person, acting alone, can be the holder of the instrument. The instrument is "payable to an identified person." The "identified person" is X and Y acting jointly. Section 3-109(b) and Section 1-102(5)(a). Thus, under Section 1-201(20) X or Y, acting alone, cannot be the holder or the person entitled to enforce or negotiate the instrument because neither, acting alone, is the identified person stated in the instrument.

Minn. Stat. § 336.3-110, cmt. 4.

Article 3 of the Uniform Commercial Code further provides that "[t]he law applicable to conversion of personal property applies to instruments," and that "[a]n instrument is also converted if it is taken by transfer, other than a negotiation, from a person not entitled to enforce the instrument or a bank makes or obtains payment with respect to the instrument for a person not entitled to enforce the instrument or receive payment." Minn. Stat. § 336.3-420(a).

Thus, the "takeaway" from this article is that when lenders are presented with a jointly payable check made payable to "John Doe *and* Jane Roe," the "payor / drawee" bank should refuse to make payment on the check unless both "John Doe *and* Jane Roe" have endorsed the same. In like manner, a lender that would be the "depository" bank for the funds from a jointly payable check should not accept any funds unless *both* "John Doe *and* Jane Roe" have endorsed the check. That way, whether your institution is the "payor / drawee" bank and/or the "depository" bank, you will significantly minimize your institution's liability exposure for any conversion claims that may otherwise be brought by a joint payee of a negotiable instrument.

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HOW NEW CREDIT, MODIFICATIONS, AND EXTENSIONS CAN IMPACT MORTGAGE PRIORITY

Real Estate often serves as the primary collateral for a loan, and for good reason. Compared to personal property, real estate tends to depreciate less, cannot be absconded with, and oftentimes is simply more valuable than items of personal property. For this reason, lenders usually take significant efforts to ensure they obtain a first priority lien against the real estate, including obtaining title opinions or title insurance. Challenges can arise where a borrower needs more credit in the future or the parties want to modify or extend the loan in the future; some actions can impact the priority of the mortgage when there have been subsequent liens or mortgages against the property.

Extending New Credit

In the most basic transaction, a customer borrows a fixed sum secured by a mortgage, repays the principal and interest usually over a number of years, and the mortgage is satisfied. Many loans do not follow this pattern and instead may involve partially paying the original amount down, borrowing more later, or even combining or consolidating multiple loans over time. Other transactions are devised from the outset as revolving lines of credit, contemplating a fluctuating principal throughout the life of the loan. Each of these circumstances may lead to slightly different results in a dispute between lienholders down the line.

Of course, the basic rule is that the first mortgage or lien of record has priority up to its maximum principal amount over a subsequent lien and will be able to wipe out junior liens in the event of a later foreclosure. But whether that mortgage will remain in a senior position over subsequent liens in the event of an advance of new credit depends on the terms of the original mortgage and the circumstances of the new funding advanced.

As a general rule, even with a mortgage that contains a future advance cause—providing that the mortgage secures not only the existing debt, but all other future advances by the lender to the borrower—a subsequent lienholder may have priority over those new advances if they were optional, as opposed to mandatory, under the terms of the note and mortgage. For example, if a lender voluntarily enters into a second loan with the borrower, relying on the existing mortgage with a future advance clause as security, the mortgage may only have priority over an intervening lienholder as to the original principal balance, because the new loan was an optional advance of new funds.

On the other hand, if a lender enters into a transaction such as a construction loan, subsequent advances will take priority if they are mandatory under the original transaction. In most construction loans, the lender agrees to advance funds as construction progresses, provided certain conditions are met. These subsequent advances will have priority over subsequent liens and mortgages against the property, because the lender is obligated to advance those funds.

The exception to this mandatory-verse-optional advance rule lies in revolving lines of credit. A mortgage which expressly secures a revolving line of credit will retain its same priority as to all amounts outstanding regardless of the time of payments

and regardless of whether new advances are mandatory or optional under the loan agreement.

Extensions and Renewals

Mortgages can be given as security for relatively short term debts, such as operating notes or other business debts. For a variety of reasons ranging from a borrower's financial difficulties or a just a desire to extend the lending relationship, a lender might agree to extend the maturity date or renew the note.

Generally, maturity date extensions and note renewals do not impact priority of a recorded mortgage, particularly if the mortgage includes language (most do) specifying that it is intended to secure not only the original note, but all extensions and renewals thereof. Because there is a statute of limitations, limiting the timeline to foreclose a mortgage to fifteen years from the maturity date stated in the mortgage, it is a good idea to place the new maturity date of record.

It is typically better practice to record a modification of the existing mortgage noting the extended maturity date, rather than satisfying the old mortgage and recording a new one. While courts occasionally rely on concepts of fairness and equity to treat a replacement mortgage as having the same priority as the existing, this is not a guaranteed outcome, and lenders in Minnesota have found themselves behind intervening liens when replacing one mortgage with another.

Interest Changes and other Amendments

Interest rates are another term that may be changed throughout the course of a lending relationship, either because the initial note has a variable or adjustable rate term, or because the interest rate is voluntarily changed through a renewal or modification. A change of interest rate for the underlying debt will not typically impact a mortgage priority. In fact, this often does not implicate the mortgage directly, because the recorded mortgage in many cases does not specify the interest rate of the corresponding note and rather simply indicates that the mortgage secures principal and whatever interest accrues. If a mortgage does include a stated interest rate, a modification of mortgage can be recorded, noting the change of interest rate.

There can be a panoply of other changes and amendments that might be made to an existing mortgage. Whether any particular change will impact the mortgage's priority for some or all of the debt will depend on the facts and circumstances of each case. Generally, disputes over whether an amendment or change affects a mortgage's priority are not answered by a specific statute, but rather by courts analyzing the circumstances around the change, so it becomes difficult to make a firm conclusion unless a court has already analyzed the exact situation before. Courts often look at whether the change is "materially prejudicial to the holder of a junior interest," but it a challenge to know how this rule might be applied in the future. For amendments beyond extensions and interest rates changes, it may be wise to complete an updated title search to ensure there are no intervening lienholders who could raise a dispute in the future.

Summary

Having a first position mortgage is obviously an advantageous position for a lender when entering into a loan, but as the lending relationship evolves over time, keeping that position is just as important. Lenders should take care to ensure extensions, modifications, and expanding credit do not impact their mortgage priority over time.

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REGULATIONS COMING FOR OVERDRAFT AND OTHER FEES

The U.S. Consumer Financial Protection Bureau (CFPB) publishes an agenda of its planned rulemaking activities twice a year – typically in the Spring and Fall. These agendas constitute a window into the focuses and priorities of the CFPB. In early January of 2023, the CFPB published its Fall 2022 rulemaking agenda, indicating that it anticipates having this agenda under consideration during the period from December 1, 2022 to November 30, 2023. While only now in a preliminary state, the agenda shows the CFPB has set it sights on common banking practices including overdraft fees and NSF fees, and plans to expand regulation relating to credit reporting and data privacy.

The agenda lists Prerules, Proposed Rules, and Final Rules under consideration, as part of the Office of Budget and Management's broader Unified Agenda of Federal Regulatory and Deregulatory Actions. This three-stage rulemaking process is a part of the broader regulatory process used by a number of federal agencies. In the Prerule Stage, the CFPB provides notice that it is looking into a certain issue or concern. After the CFPB has researched the issue and determined that a new Rule is necessary, it will often publish a Notice of Proposed Rule Making in the Proposed Rule Stage. This allows concerned parties to make public comment on the proposed rules during a certain period. After this period, the CFPB will review the comments in the Final Rule Stage and make a decision whether to proceed with the rule, modify the rule, or potentially withdraw the rule.

The following four issues have been identified as the CFPB as being in the "Prerule" Stage, and they provide a roadmap of the direction CFPB intends to take its regulations.

1. Overdraft Fees

The changes and amendments regarding Overdraft Fees that are being considered by the CFPB pertain to Regulation Z (Reg Z). Reg Z was adopted by the Federal Reserve Board in 1969 as a part of the Truth in Lending Act of 1968. The major goals of Reg Z were to provide consumers with better information about the true costs of credit and to protect them from certain misleading practices by the lending industry. Lenders are required to disclose interest rates in writing, give borrowers the chance to cancel certain types of loans within a specified period, use clear language about loan and credit terms, and respond to complaints, among other requirements.

As the CFPB notes, Reg Z only applies to certain types of overdraft services offered by financial institutions. Whether Reg Z applies depends on whether the fees imposed in connection with the overdraft services are considered "finance charges" – which is, in turn, determined using special rules that were developed when Reg Z was first adopted. The issue identified by the CFPB involves the evolving nature of overdraft services, including how accounts can be overdrawn and how financial institutions determine whether to advance funds to pay the overdrawn amount, which have significantly changed since the adoption of Reg Z in the late 1969. The CFPB is accordingly considering whether to propose updates to Reg Z regarding these special rules. While it is not yet clear exactly what proposed rules may look like, the CFPB has been hostile to overdraft and similar fees in the past, and has issued various guidance already suggesting that certain types of overdraft fees may constitute unfair, deceptive, and abusive actions under the Consumer Financial Protection Act.

2. Non-sufficient Funds Fees

The CFPB clarifies that when consumers using deposit accounts engage in transactions that exceed their accounts' balances, sometimes "the depository institution will pay that transaction," which results in an overdraft (and typically a corresponding overdraft fee). However, in some situations "the depository institution will decline to pay the transaction" and simply charge

the consumer a fee – also known as a Non-sufficient Funds (NSF) Fee. The CFPB acknowledges that although NSF fees used to be a significant source of fee revenue from deposit accounts for depository institutions, lately some large financial institutions have voluntarily stopped charging such fees – a trend that the CFPB has labeled a "positive development" that it estimates will cause consumers to pay about 50% less of these fees, for an annual savings of about $1 billion. However, even with these voluntary trends, the CFPB's agenda item indicates that it is still "considering new rules regarding NSF fees."

3. Fair Credit Reporting Act

The CFPB states that "Congress enacted the The Fair Credit Reporting Act (FCRA) to ensure fair and accurate credit reporting, promote efficiency in the banking system, and protect consumer privacy." In order to comply with the FCRA, the Federal Reserve adopted Regulation V (Reg V), which, together with the FCRA, "impose legal duties on consumer reporting agencies, data furnishers, and users of consumer reports, and furnishers of information to consumer reporting agencies." Reg V also gives consumers the right to initiate a formal dispute if they think that their credit information has been inaccurately entered or improperly handled by a financial institution. In July of 2011, the enforcement of the FCRA through Reg V was transferred from the Federal Reserve to the newly created CFPB.

Similarly to NSF fees, in its agenda, the CFPB simply states that it "is considering whether to amend Regulation V." This could take a number of forms; however, the CFPB may have already signaled one proposed concern. On January 11, 2023, the CFPB proposed the establishment of a new public registry of terms and conditions in many "form" contracts that claim to waive or limit consumer rights and protections. The CFPB listed several examples of terms and conditions that would be included in the registry, and one category included contract provisions that would purport to "undermine credit reporting rights" such as the ability of aggrieved consumers to pursue legal action to remedy alleged violations of the FCRA. If this pattern holds true, banking institutions should be on the lookout for more regulation seeking to bolster consumers' credit reporting rights.

4. Personal Financial Data Rights

The CFPB is providing advanced notice of its intention to convene a panel under the Small Business Regulatory Enforcement Fairness Act (SBREFA) and issue a report summarizing feedback received from the panel regarding personal financial data rights. Specifically, the Panel will analyze Section 1033 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which generally provides that a covered entity (e.g., a bank) must make transaction data and other information concerning a consumer financial product or service obtained by a consumer from the covered entity available to consumers, upon request. Section 1033 also states that the CFPB must issue rule standards to promote the development and use of standardized formats for such information. The Bureau's next step in the rulemaking is to convene the SBREFA panel and issue a report summarizing feedback received from the panel, which it expects to be issued in February of 2023.

Takeaway

Despite the general trend exhibited by larger banks toward eliminating or reducing overdraft and NSF fees, the CFPB has continued criticizing these fees, which it categorizes as "junk fees." Last year in January 2022, the CFPB requested information on these fees, and in October of 2022 issued guidance on unfair practices regarding "surprise" overdraft fees. While these issues are still in the Prerule Stage, their inclusion in the CFPB's agenda along with its concerns about credit reporting and personal financial data indicates the CFPB's growing focus on creating further protections for banking consumers with the reinvigoration of its regulatory powers. As these proposals move through the rulemaking process, details are likely to clarify just how far the CFPB intends to go.

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