

CREDIT UNION LIABILITY FOR NEGLIGENCE INVOLVING ONLINE FRAUD

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Financial institutions face more than regulatory compliance and UCC4A risk. A credit union that commits egregious behavior may be subject to a negligence suit. While much harder to prove, negligence can result in much greater damage awards.

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BAD CITIZENS

Marsha and Michael Shames-Yeakel, a couple from Indiana, had \$26,500 stolen from their home equity line of credit (HELOC) linked to a business checking account. Both accounts were held by Citizens Financial Bank. Citizens only used username and password to protect online banking accounts (i.e. single factor authentication) through their provider (Fiserv). The money was wired to Austria and could not be recovered. Citizens held the Shames-Yeakels liable for the loss and began billing them. When the Shames-Yeakels refused to pay, Citizens reported their account as delinquent to the national credit bureaus and also threatened to foreclose on their home. Citizens justified their actions by language in the online banking agreement releasing the bank from liability.

The Shames-Yeakels next steps were to complain to the federal Office of Thrift Supervision. The Office of Thrift Supervision stated Citizens actions were legal based on these facts:

1. The Electronic Funds Transfer Act doesn't protect HELOCs;
2. Truth in Lending only covers personal, not business accounts.

The Office of Thrift Supervision concluded that the HELOC was a business account because it was linked to a business checking account. Undeterred, the Shames-Yeakels then sued Citizens for violations of the Truth in Lending Act, the Fair Credit Reporting Act, the Electronic Funds Transfer Act, the Indiana Uniform Consumer Credit Code and for common-law negligence and breach of contract. The negligence claim included an argument for mental anguish. Citizens asked the court to dismiss the case by filing a motion for summary judgment.

The Shames-Yeakels voluntarily chose to drop the Indiana Commercial Code (UCC 4A) claims and the breach of contract claims, probably because the common law negligence claims offered the opportunity not just for restitution but for a large punitive damages award. The judge also agreed with the Office of Thrift Supervision and dismissed the Electronic Funds Transfer Act claims. The judge stated that the Shames-Yeakels could only use the Fair Credit Reporting Act insofar as Citizens failed to report to the national credit reporting bureaus that the debt was a disputed debt.

However, the judge allowed the Truth in Lending and negligence claims to go forward. As to Truth in Lending, by looking at relevant caselaw the judge found a requirement to look at the substance rather than the form of transactions, finding that the “Plaintiffs’ use of their home equity line of credit appears overwhelmingly personal in nature.”

In allowing the negligence action to proceed, the court found that in Indiana and many other states, financial institutions have a duty to protect customers’ confidential information. “If this duty ... is to have any weight in the age of online banking,” she wrote, “then banks must certainly employ sufficient security measures to protect their customers’ online accounts.” The judge found that Citizens may have failed in that duty by employing only single-factor authentication. In other words, evidence that Citizens failed to follow FFIEC guidelines could be used as evidence of negligence at trial. Moreover, under Indiana law, if the jury found that Citizens violated Truth in Lending laws, that would constitute *negligence per se* and shift the burden of proof away from the plaintiffs and on to the bank. ♦

WHAT IS NEGLIGENCE?

Negligence is a legal term of art meaning that a plaintiff can collect a money award (damages) from a defendant if the defendant had a duty to protect the plaintiff from some sort of foreseeable harm (physical, emotional, financial, etc.) and failed to do so. Negligence can be found under common law, that is, there need not be a statute or regulation that specifically spells out how the plaintiff can recover.

Because negligence is the result of an accident or unintentional behavior by the defendant, the plaintiff has the burden of proof. (American law, as a general rule, does not favor granting damages for accidents). In most cases, the plaintiff must show that the defendant had a duty to use care with respect to the plaintiff and that the defendant failed to exercise the degree of care required, and that it was the defendant’s action or inaction which caused harm to the plaintiff. The duty and the degree of care required can potentially be modified by contract, relevant statutes, and by the experience or activities of the plaintiff and defendant. If a defendant is found negligent, it is possible that the plaintiff will not only recover actual damages, but may be entitled to punitive damages. ♦

DUTY TO SECURE DATA

Irrespective of any statutes, many courts have held that financial institutions have a common law duty to protect consumer's data. A failure to protect that data can expose the financial institution to a negligence suit. This means that a financial institution can still be liable to a consumer for the unforeseeable criminal acts of a third party. (The Gramm-Leach-Bliley Act likely imposes this duty in any event).

Plaintiffs can use a wide variety of evidence to demonstrate that the financial institution breached this duty. Non-compliance with FFIEC, NCUA, or state requirements for data protection will likely be offered. A credit union may be placed in a tough spot because state or federal examinations may not be discoverable or entered into evidence. Under federal law, the NCUA can refuse to produce evidence or testimony in a civil lawsuit against the credit union.

The financial institution can counter with some of the same evidence that it would need in a UCC 4A case, namely compliance with online security guidelines published by regulatory agencies, same level of security as peer institutions, and good faith in processing transactions.

Plaintiffs may also offer evidence that the credit union violated a law that governs the duty to secure data. This is called *negligence per se* and the consequences vary from state to state. In some jurisdictions this shifts the burden from the plaintiff to the defendant; that is the credit union must show proof that it was not negligent rather than requiring the consumer to prove the defendant was negligent. In a minority of states, such as Michigan, it is merely additional evidence of negligence which is submitted to the jury. To take advantage of negligence per se, the consumer must show that the statute was intended to protect the consumer and there are *criminal penalties* for failing to obey the law. ♦

IMPORTANT DIFFERENCES BETWEEN NEGLIGENCE AND STRICT LIABILITY (UCC 4A)

UCC 4A is another way a consumer may recover due to loss as a result of online fraud. The key differences between a UCC 4A and a negligence claim are as follows:

UCC 4A imposes *strict liability* on a financial institution; the negligence of the consumer and the degree of care used by the financial institution are *irrelevant*. By contrast, the care used by the financial institution and the negligence of the consumer can be used to reduce or remove entirely the liability of the credit union.

A financial institution may be able to *limit* its negligence liability through an agreement with the consumer. The credit union cannot limit its liability under UCC 4A.

Under most negligence actions, the consumer has the burden to prove the elements of negligence before obtaining damages. Under UCC 4A, most of the burdens of proof are on the financial institution to show compliance.

A financial institution may be liable for some additional damages for failing to meet UCC 4A requirements, but punitive damages cannot be imposed. By contrast, egregious breaches of the duty of care may result in punitive damages added on to the actual damages the consumer suffered as a result of the credit union's negligence.

In short, the UCC 4A claim is much easier to prove, but the negligence claims are far more lucrative for a victorious plaintiff. ♦

THE LIMITS OF LIMITING LIABILITY

In the *Citizens* case, the bank had a disclaimer on their *Citizens Business Online Banking Application* which stated:

“We will have no liability to you for any unauthorized payment or transfer including wire transfer made using your password that occurs before you have notified us of possible unauthorized use and we have had a reasonable opportunity to act on that notice.”

So why didn't the court simply toss the case based on the Shames-Yankels acceptance of these terms and conditions? The main reason is that *Citizens* did not argue that this clause exempted them from the duty to secure the Shames-Yankels account.

Courts may enforce exculpatory clauses such as the one *Citizens* required of the Shames-Yankels. There are usually three circumstances where the courts will not enforce the clause in a negligence case: attempts to limit liability for reckless, wanton, or gross behavior; where the contract results from grossly unequal bargaining power, and when such a term is contrary to protecting the public from harm. The court might contend that allowing a party to limit liability for negligence would provide a bank with little incentive to act with at least a minimal standard of care, although there are several arguments to the contrary.

This clause in the contract was not entirely useless, however. The limit of liability clause effectively eliminated any breach of contract claim that the Shames-Yankels might have had against *Citizens*. To be valid, it is important for the financial institution to make very clear that the intent to disclaim liability. Courts will not broadly interpret these clauses and instead construe them narrowly against a defendant. ♦

INDEMNITY CHECKLISTS

Does the indemnity clause provide:

1. *The identity of the indemnified organization?*
2. *A list of the claims indemnified?*
3. *A list of the types of damages indemnified?*
4. *A list of the claims and types of damages excluded?*
5. *A list of additional remedies not otherwise available to the consumer?*
6. *The extent to which legal costs are recoverable by the “successful” party? ♦*

FOUR KEY POINTS ON NEGLIGENCE AND INDEMNITY CLAUSES

When a financial institution is developing an indemnity clause as part of a member Online Banking Agreement, the following principles should be kept in mind:

1. Courts will look at the plain language of the indemnity clause and not provide broader protection other than what is written.
2. Indemnity clauses should be construed as allocating the risk.
3. Sophisticated parties, such as businesses, are generally free to write a contract allocating all the risk to one party (subject to statutory law and public policy).
4. Where there is unequal bargaining power between the parties, indemnity clauses are still enforceable but are less likely to be enforced depending on statutory law, public policy, and the reckless conduct of the defendant.

The same best practices that a credit union should take to protect the institution against a UCC4A claim are exactly same that will help a credit union in a negligence action.

