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For Our Eyes Only

Attorney-Client Privilege and Its Application to Banks

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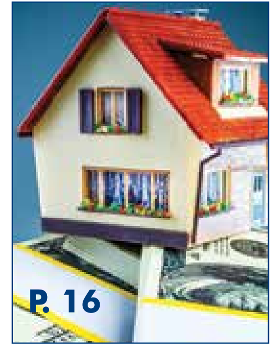

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View from the Chair

by
Mark A. Graham
EVP, Wealth Advisory Services
Wilmington Trust

Chairman
Delaware Bankers Association

"The best strategy is to remain agile and flexible in the face of the myriad of issues that confront us."

One hundred years ago the renowned architect Frank Lloyd Wright was commissioned to design the Imperial Hotel in Tokyo. The task presented unique challenges given the area's reputation for devastating earthquakes. Wright studied the situation and found that eight feet below what seemed to be stable ground lay a sixty-foot bed of soft mud. His proposal was to float the entire structure of the hotel on this mud almost like a boat. Wright's design was met with skepticism and even ridicule, but ultimately the hotel was built using his solution. It didn't take long for Wright's idea to be tested, for not long after it was completed, in 1922, Tokyo suffered a devastating earthquake. Most of the city was in ruins, but not the Imperial Hotel. The building was shaken but not damaged.

After the financial upheavals and tremors of the last decade many in the financial services industry might feel like we've been in an earthquake zone. There have been speculation bubbles bursting, changing administrations, new laws to deal with, and new regulatory agencies on the backs of those new laws. And just when you're getting acclimated to the changes, here come more changes!

On the state level here in Delaware we have a new governor and a fresh new legislature. While most of the new players are familiar faces, there will still be new legislative issues and proposals. In the General Assembly in addition to the budget related issues, there will be prized-linked savings accounts, further restrictions on pay-day lending, the elimination of the estate tax, super priority liens for homeowners associations with respect to unpaid dues and assessments, and abandoned property issues.

As active as the agenda in Delaware is, it's hardly a ripple compared to the potential changes in Washington. With the sea change in the White House and Congress there's talk of major regulatory reform that runs the gamut from tweaking, to selective dismantling to outright repeal of Dodd-Frank. Will the CFPB be revised or replaced, or survive as created? Aside from these issues, there are the now familiar challenges of data breaches, credit union competition, and many others. The times are indeed "interesting," and becoming more so each day.

Those are just a few of the challenges we face as we begin the year with new administrations in Dover and Washington. No doubt there are even more issues just over the horizon. In many ways the economic climate can be likened to the conditions Frank Lloyd Wright faced: some seemingly solid ground over sixty feet of mud. The best strategy for the financial services industry is to remain agile and flexible in the face of the myriad of issues that confront us. Frank Lloyd Wright's design of that hotel survived the tremors because it was adaptable to the conditions that confronted it, usually without warning. Your association strives to meet the future in much the same way. Tom Collins is in Legislative Hall each day the legislature is in session to advise and advocate for our industry, while our partners at the ABA keep us apprised of developments in the nation's capital. We all look forward to working closely together in the months and years ahead.

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President's Report

by
Sarah A. Long
President, CEO & Treasurer
Delaware Bankers Association

"Change can lead to innovation and that has always been a hallmark of the relationship between Delaware and the financial services industry. "

Oh our Delaware! Our beloved Delaware!
For the sun is shining over our
beloved Delaware,
Oh our Delaware! Our beloved Delaware!
Here's the loyal son that pledges,
Faith to good old Delaware!

"Our Delaware" written by George B. Hynson, was published in 1906. The musical score was composed by Will M. S. Brown, and became the official state song in 1925. Each verse recognizes one of Delaware's three counties.

Oh the hills of dear New Castle,
and the smiling vales between,
When the corn is all in tassel,
and the meadowlands are green;
Where the cattle crop the clover,
and its breath is in the air,
While the sun is shining over
our beloved Delaware.

Where the wheat fields break and billow,
in the peaceful land of Kent,
Where the toiler seeks his pillow,
with the blessings of content;
Where the bloom that tints the peaches,
cheeks of merry maidens share,
And the woodland chorus preaches,
a rejoicing Delaware.

Dear old Sussex visions linger,
of the holly and the pine,
Of Henlopen's jeweled finger,
flashing out across the brine;
Of the gardens and the hedges,
and the welcome waiting there,
For the loyal son that pledges faith
to good old Delaware.

Although it would be difficult today to find cattle cropping the clover or anything else in New Castle County, our State song does still invoke feelings of nostalgia for the past. I remember what the Concord Pike looked like before the Mall was built, how arduous the trip was from Wilmington through Kent County to the beaches before Route 1 was completed, and how my Mother would carefully place plastic protectors on her shoes when we would venture out as a family to visit the Rehoboth boardwalk so as to not get her heels stuck between the boards.

So why the trip down memory lane? According to a 2013 study done by Dr. Tim Wildschut, of the University of Southampton, and colleagues from Tilburg University, the University of Missouri-Columbia, and the University of Surrey, "Nostalgia seems to spur optimism for the future. Thinking fondly about the past can make you more excited about what's to come."

And excited about what is to come is exactly what I am! There is nothing like the inauguration of new leadership in the State to instill a sense of hope and promise for the future. In January, Delaware inaugurated a new Governor and Lt. Governor, a new Mayor of its largest city, Wilmington as well as a new President of City Council, a new County Executive of its largest County, New Castle, as well as a new President of County Council, and the first woman and the first African-American to represent Delaware in the House of Representatives in Washington.

By the very definition of change, things will be different. That said, if we support and build strong working relationships with our new leaders, positive changes will occur. Change can lead to innovation and that has always been a hallmark of the relationship between Delaware and the financial services industry. The majority of the more than 37,000 employees in Delaware's banking industry can be thankful for the Financial Services Development Act enacted in 1981. So, although there may be fewer wheat fields billowing in Kent County than there were 100 years ago, and some op centers may have replaced some of New Castle's corn tassels, the sun is still shining over our beloved Delaware.

Sarah

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Leadership in business brings with it burdens of leadership. Leaders can be targets for the discontented and litigious. At other times, leaders must themselves initiate litigation when negotiation fails. Sometimes, the pace of litigation defies conventional deadlines. Sometimes, your position is logical but there are no governing precedents either way. Sometimes, mountains must be moved overnight.

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Cybersecurity Forum & Luncheon Features All-Star Panel

Approximately 40 attendees gathered at the University & Whist Club in Wilmington November 10th for the Delaware Bankers Association Cybersecurity Forum. The event, sponsored by Essextec, featured an all-star panel of federal, state, and industry professionals for a timely discussion of the latest cyber threats and the strategies undertaken to combat them! Valuable information included: whom to contact and what to do before, during and after a cybersecurity incident, whether confined to one organization or industry wide. The forum was moderated by Edward McAndrew, Partner, Ballard Spahr LLP, (a former federal cybercrime prosecutor), and featured panelists: Michael DaGrossa, VP, Business Risk Services / CISO, Essextec; Scott Hagerty, Info Security Global Cyber Threat Exercise Planner, Citi; Adam Bulava, Vice President, Global Technology, JPMorgan Chase & Co.; Jeffrey A. Reising, Special Agent, FBI, Baltimore Division; Greg Gist, Deputy Director, FS-ISAC (Financial Services - Information & Analysis Center); and, Renee Hupp, DEMA Terrorism Preparedness Planner.

Regulatory Compliance School

25 Compliance professionals attended the 2016 Regulatory Compliance School November 15th, 16th, and 17th at the University & Whist Club in Wilmington. Attendees received a comprehensive review of the federal laws and regulations that impact the financial

services industry. The school was taught by the professionals at FIS Risk, Information, Security and Compliance (RISC) Solutions. Tuesday's session focused on Lending Compliance and was taught by Alice Judd and Elizabeth Rozsa. Wednesday Diane Banks and Elizabeth Rozsa taught Deposit Operations Compliance. The final session featured Credit Card Lending Compliance and was faciliated by Bob Cardwell and Suzanne Robeson. New this year were 90 minutes of Ethics instructions each day. The school was approved for 18 credits (6 credits per day) CPE, CRCM, for DE & PA, including 4.50 Enhanced Ethics credits (1.5 per day).

DBA Website Relaunch Features Responsive Interactive Design Across All Platforms

The Delaware Bankers Association recently re-launched its website, www.debankers.com. The previous design was created back in 2007 and had grown out-of-date. The old design was created in the day when the only online choices were desktops and laptops. What was functional then became increasingly frustrating today in the age of tablets and smartphones. The new site is fully interactive across all platforms. It also features a carousel at the top of the front page that highlights the hottest coming events. We invite you to visit the new site on your desktop, tablet, phone... any device you use to access the web.

At Right: The New DBA Website as viewed on a tablet

New ABA Course Portal Provides Expanded Professional Development Option

Along with the new DBA website, we're happy to announce a refreshed portal for courses from the American Bankers Association. DBA members may take advantage of the full range of educational opportunies in several categories. Visit the education page on the DBA website, accessable from the main page via the menu bar, or the large Education icon. There you'll find links to ABA Briefings, ABA Faciliated Online Training, ABA Self-Paced Online Training, and ABA Certificate Programs. ABA Briefings provide updates on the most current issues in banking. Faciliated Courses deliver a classroom experience with live instructors and classmates but with the convenience of online. Self-paced training features over 200 courses that you take at your speed and to fit your schedule. ABA Certificate Programs help you build the skill needed in a wide range of specific categories.

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Cover Story

For Our Eyes Only

Understanding The Attorney-Client Privilege and Its Application to Banks

by
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The attorney-client privilege is a rule of evidence that prevents the adverse party in a lawsuit from obtaining access to certain communications. If properly understood and wellmanaged, this privilege offers a useful tool for protecting the bank in litigation while maintaining effective relationships with regulators. On the other hand, a lack of appropriate knowledge of the privilege could have serious adverse consequences if litigation should arise.

A non-lawyer banker reading this article may be thinking that the attorney-client privilege is something only lawyers need to know about. In addition, some bank attorneys may mistakenly believe that simply labeling all of their communications as "attorney-client privileged" represents a fail-safe option. Unfortunately, an adequate understanding of the privilege on the part of the persons who might have invoked it, or prevented its subsequent waiver, is often arrived at too late. This article reviews certain well-established rules that courts apply in interpreting the privilege. In light of the privilege's importance, all employees should have at least a basic understanding of how their actions or inactions may affect its availability.

The attorney-client privilege is intended to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law."[1] It is one of the oldest privileges for confidential communications recognized under the law. The privilege covers both natural and non-natural corporate persons, and it extends to communications between a firm's legal counsel and persons employed at any level of the organization. In this regard, the U.S. Supreme Court recognized in *Upjohn Co. v. United States*[2] that:

Middle level—and indeed lower-level—employees can, by actions within the scope of their employment, embroil the corporation in serious legal difficulties, and it is only natural that these employees would have the relevant information needed by corporate counsel if he is adequately to advise the client with respect to such actual or potential difficulties.[3]

The attorney-client privilege is an exception to the strong presumption under U.S. law that the facts underlying any legal dispute are fully discoverable. In this regard, the Second Circuit Court of Appeals has opined that because the attorney-client privilege "stands in derogation of the public's 'right to every man's evidence, ... it ought to be strictly confined within the narrowest possible limits consistent with the logic of its principle.'"[4] Awareness of this tension between the attorney-client privilege and public policy favoring open discovery is important because if there is any reason for doubt regarding the privilege's applicability, a court is likely to err on the side of inapplicability.[5] Hence, the need for all employees to know how the privilege comes into being and how their personal actions may cause it to be forfeited.

The attorney-client privilege shields against discovery: "(1) a communication between client and counsel that (2) was intended to be and was in fact kept confidential, and (3) was made for the purpose of obtaining or providing legal advice."[6] In this regard, it is important to note that "the protection of the privilege extends only to communications and not to facts."[7] Thus, "[t]he client cannot be compelled to answer the question [in the course of litigation], 'What did you say or write to the attorney?' but may not refuse to disclose any relevant fact within his knowledge merely because he incorporated a statement of such fact into his communication with to his attorney."[8]

In order to be covered by the attorney-client privilege, the communication must have been made between a client and their legal counsel. Therefore, giving an attorney after-the-fact notice of sensitive discussions (e.g., by copying them on the meeting minutes) will not trigger application of the privilege.[9] Moreover, merely including an attorney in the discussions likewise will not suffice. Rather, in establishing the privilege, the necessary first step is to create an attorney-client relationship by requesting legal advice. In this regard, "a party cannot create the [attorney-client] relationship based on his or her own beliefs or actions."[10] As soon as a given matter is perceived to present legal sensitivity, an explicit, documented request for advice from counsel should be made.

The attorney-client privilege "protects only those communications that are confidential and are made for the purpose of seeking or receiving legal advice."[11] To this end, communications made by and to laypersons acting as agents for attorneys in internal investigations are likely to be protected by the attorney-client privilege.[12] In addition, so long as one of the primary purposes of an internal investigation was to obtain or provide legal advice, the privilege will attach " regardless of whether [the] internal investigation was conducted pursuant to a company compliance program required by statute or regulation, or was otherwise conducted pursuant to company policy."[13] On the other hand, the mere fact that an attorney finds certain information helpful in providing legal advice does not render that information privileged.[14]

As noted above, the attorney-client privilege covers communications between an inhouse attorney and the firm's employees. However, demonstrating that the communication in question involved a request for legal advice may be challenging. This is because in-house attorneys routinely provide both legal advice and business advice, and it may be impossible to separate the two. The U.S. District Court for the District of Columbia recently addressed this issue in *FTC v. Boehringer Ingelheim Pharms., Inc.*[15] as follows:

[I]n-house counsel may have certain responsibilities outside the lawyer's sphere, and, as a result, the corporation can shelter the attorney's advice only upon a clear showing that the attorney gave it in a professional legal capacity. *In re Sealed Case*, 737 F.2d at 99; *see also Neuder v. Battelle Pacific Nw. Nat'l Lab.*, 194 F.R.D. 289, 292 (D.D.C. 2000) (finding that communications are not privileged where in-house counsel is acting solely in his capacity as a business advisor and the legal advice, if any, is merely incidental to business advice.[16]

One way of avoiding the above issue is to engage outside counsel, which may make sense for reasons besides the attorney-client privilege; among other things, having in-house counsel oversee an "independent" review to be performed by the compliance department or an outside consulting firm involving activities that the attorney supports on a day-to-day basis necessarily undermines the exercise by introducing bias. Another option is to require that in-house counsel specify when they are giving business advice versus legal advice. In actual practice, however, advice is often not amenable to clear-cut categorization. In addition, if stressed too strongly, this approach can interfere with the closeness to the business that is a hallmark of effective in-house legal support.

In the absence of direction provided by an attorney, a risk assessment performed by an outside consulting firm will not be recognized as attorney-privileged, and, contrary to commonly-held belief, the fact that the consultants in question were retained through a law firm may not change that result.[17] For example, in evaluating whether communications from an accounting firm were protected by attorney-client privilege in *Schlicksup v. Caterpillar, Inc.*,[18] the U.S. District Court for the Central District of Illinois noted that:

[W]hat is vital to the privilege is that the communication be made in confidence for the purpose of obtaining legal advice from the lawyer. If what is sought is not legal advice but only accounting service ... or if the advice sought is the accountant's rather than the lawyer's, no privilege exists. [19]

In addition, because the communication to the attorney must be made in confidence, it is important to limit the persons with knowledge of those communications to those with a *bona fide* "need to know."[20] Furthermore, the privilege may be waived if the resulting legal advice is distributed to "employees of the corporation who are not in a position to act or rely on [it]."[21] Thus, a written report summarizing the findings of an attorney-client privileged investigation or risk assessment should always be delivered first to the General Counsel, who will then decide whether and to what extent broader distribution is warranted.

Subject to narrow exceptions, including the limited statutory exception for financial institutions discussed below, voluntary

(continued on p. 12)

(continued from p. 11)

disclosure of an attorney-client privileged communication waives the privilege. [22] Moreover, the disclosure of any part of a communication waives the privilege for all communications related to the same subject matter.[23] Thus, the careless inclusion of attorney-client privileged information in an internal communication (e.g. in an email message) could have far-ranging adverse consequences.

Another, closely-related rule of evidence is the "work product" privilege. This privilege covers documents that were prepared in anticipation of litigation to provide assistance to counsel. In this regard, it is essential to the application of the work product privilege that the materials were prepared at least in part *because of* the prospect of impending litigation, and not just in the ordinary course of business.[24] This privilege may apply even if the attorney-client privilege does not. For example, in *Szulik v. State Street Bank & Trust Co.*,[25]after first concluding that a series of email messages between bank employees who were conducting a review of client accounts was not protected by the attorney-client privilege becausethey did not concern a request for, or the receipt of, legal advice, the U.S. District Court for the District of Massachusetts held that the work product privilege did apply because the underlying review had been requested by bank counsel in anticipation of litigation.[26]

Lastly, as noted above, the law treats financial institutions differently than other firms with respect to the waiver of privileged information. Namely, in general, the voluntary sharing of such information with a state or federal banking regulator, or with the Consumer Financial Protection Bureau ("CFPB"), waives the privilege only with respect to the regulator to whom the information was given. Specifically, the applicable federal law provides that:

The submission by any person of any information to the Bureau of Consumer Financial Protection, any Federal banking agency, State bank supervisor, or foreign banking authority for any purpose in the course of any supervisory or regulatory process of such Bureau, agency, supervisor, or authority shall not be construed as waiving, destroying, or otherwise affecting any privilege such person may claim with respect to such information under Federal or State law as to any person or entity other than such Bureau, agency, supervisor, or authority. [27]

Please note that interpretations of the above statutory language establishing what is known in the law as "selective waiver" should only be made by legal counsel, including with respect to whether a contemplated disclosure would occur "in the course of any supervisory or regulatory process."

The ability of a financial institution to choose to share privileged information with their regulators promotes ongoing transparency and becomes extremely important if agency enforcement action is threatened.[28] However, this ability also presents some serious potential pitfalls. For example, the above statutory language does not extend the selective waiver to state attorneys general or other state agencies that do not constitute a "State banking supervisor."

Yet, the CFPB has been unwilling to provide assurances that it will not share information with such non-banking state parties.[29] If the CFPB were to do so, the subject financial institution would lose the protections of privilege with respect to all parties (i.e. not just government bodies) for both the information that was shared and all related communications. Therefore, the critical importance of discussing in advance with legal counsel all contemplated voluntary disclosures of information—whether to the CFPB or to any government agency—cannot be overstated.

In sum, if properly understood and applied, the attorney-client privilege represents a useful tool that encourages clients to seek legal advice by shielding both their communications to counsel, and the resulting advice, against discovery in litigation. In this regard, banks enjoy a special ability to share information on a voluntary basis with their regulators without forfeiting applicable privileges with respect to other parties. Extreme care should be taken in attempting to navigate the attorney-client privilege, and that care should always include seeking the assistance of competent legal counsel.

Mark T. Dabertin is special counsel in the Financial Services Practice Group of Pepper Hamilton LLP, resident in the Berwyn office. Mr. Dabertin has over 25 years of broad-based experience in financial services law and consumer and regulatory compliance. Mr. Dabertin's career includes extensive experience in consumer lending, safety and soundness, and anti-money laundering. His work in consumer and regulatory compliance at large financial institutions has been marked by innovations that resulted in fundamental structural changes to existing firm-wide compliance activities, including with respect to regulatory change management, risk assessments, and vendor management. Bank examinations that Mr. Dabertin either managed or co-managed while working in consumer and regulatory compliance positions included exams focused on fair lending, data privacy, and add on products. For most of these examinations, he authored the bank's written responses to any legal or regulatory issues cited in supervisory letters.

Notes:

1- *Upjohn Co. v. United States,* 449 U.S. 383, 389 (1981).
2- 449 U.S. 383 (1981).
3- *Id.* at 391.
4- 482 F.2d 72, 81 (2d Cir.), *cert. denied,* 414 U.S. 867, 38 L. Ed. 2d 86, 94 S. Ct. 64 (1973) (quoting 8 Wigmore, Evidence § 2291 (McNaughton rev. 1961).
5- *See, FTC v. Boehringer Ingelheim Pharms., Inc.,* 180 F. Supp. 3d 1, 4, (D.D.C. 2016): "Courts tolerate the privilege only to the extent necessary "to encourage 'full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and the administration of justice.'" *Swidler & Berlin v. United States,* 524 U.S. 399, 403, 118 S. Ct. 2081, 141 L. Ed. 2d 379 (1998) (quoting *Upjohn,*449 U.S. at 389)."
6- *In Re City of Erie,* 473 F.3d 413, 419 (2d Cir. 2007).
7- Upjohn, 449 U.S. at 395.
8- *Id.* at 396.

9- See, Wultz v. Bank of China Ltd., 304 F.R.D. 384, 391 (S.D.N.Y. 2015): "[W]e are unaware of any case law suggesting that a person's collection of information is protected merely because the person harbors a plan to provide the information later to an attorney — particularly where there is no proof that the attorney sought to have the individual collect the information at issue;" *See, also, Neuder v. Battelle Pac. Northwest Nat'l Lab.,* 194 F.R.D. 289, 295 (D.D.C. 2000): "[D]ocuments prepared by non-attorneys and addressed to non-attorneys with copies routed to counsel are generally not privileged since they are not communications made primarily for legal advice."

10- Egiazaryan v. Zalmayev, 290 F.R.D. 421, 429 (S.D.N.Y. 2013) (emphasis added).

11- In re Keeper of the Records (Grand Jury Subpoena Addressed to XYZ Corp.), 348 F.3d 16, 22 (1st Cir. 2003).

12- In re Kellogg Brown & Root, Inc., 756 F.3d 754, 758 (D.C. Cir. 2014).

13- Id. at 760.

14- Wutlz, 304 F.R.D. at 391.

15- 180 F. Supp. 3d 1, (D.D.C. 2016).

16- Id. at 16-17 (quotation marks omitted).

17- "[N]othing in the policy of the privilege suggests that attorneys, simply by placing accountants, scientists or investigators on their payrolls and maintaining them in their offices, should be able to invest all communications by clients to such persons with a privilege the law has not seen fit to extend when the latter are operating under their own steam." *United States v. Pipkins,* 528 F.2d 559, 563 (5th Cir. 1976) (quoting, *United States v. Kovel*, 296 F.2d 918, 921 (2d Cir. 1961)).

18- 2011 U.S. Dist. LEXIS 102099, *9 (C.D. Ill. 2011).

19- Id. at *9.

20- See, e.g., Graff v. Haverhill North Coke Co., 2012 U.S. Dist. LEXIS 162013, * 36 (S.D. Ohio 2012) (in finding certain contested documents privileged, the court noted that the documents in question were explicitly marked as access restricted to persons with "a direct need to know"). One major downside to labeling all communications to and from counsel as attorney-client privileged is that it unnecessarily restricts the free flow of information within the firm.

21- Scott v. Chipotle Mexican Grill, Inc., 94 F. Supp. 3d 585, 598 (S.D.N.Y. 2015).

22- "[S]ubsequent disclosure to a third party by the party of a communication with his attorney eliminates whatever privilege the communication may have originally possessed, whether because disclosure is viewed as an indication that confidentiality is no longer intended or as a waiver of the privilege." *In re Horowitz,* 482 F.2d 72, 81 (2d Cir. 1973).

23- "[W]hen a party discloses part of an otherwise privileged communication, he must in fairness disclose the entire communication, or at least so much of it as will make the disclosure complete and not misleadingly onesided." *Von Bulow v. Von Bulow,* 114 F.R.D. 71, 79-80 (S.D.N.Y. 1987).

24- Navigant Consulting, Inc. v. Wilkinson, 220 F.R.D. 467, 477 (N.D. Tex. 2004).

25- 2014 U.S. Dist. LEXIS 110447, 2014 WL 3942934 (D. Mass. Aug. 11, 2014).

26- Id. at * 13.

27- 12 U.S.C. § 1828(x).

28- See, CFPB Bulletin 2013-06 (Responsible Business Conduct: Self Policing, Self Reporting, Remediation, and Cooperation) , which describes certain "responsible conduct," including the voluntary disclosure of relevant information, that "may favorably affect the ultimate resolution of a Bureau enforcement investigation ".

29- For additional information regarding the CFPB's position on disclosing privileged information to other entities, see CFPB Compliance Bulletin 2015-01 (Treatment of Confidential Supervisory Information) and 12 CFR §1070, et seq.

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FHLBank System:

An Enduring Partner in a Changing World

by
John K. Darr

Senator Tom Carper helps Habitat for Humanity of New Castle County in Phase 1 of Walnut Ridge.

John K. Darr is a 34-year Delaware resident and 46-year banker. His career spans the country, from large West-Coast S&Ls to a Wall Street investment bank, culminating in 16 years as the CEO of the FHLBanks Office of Finance, which issues and services all debt securities for the 11 Federal Home Loan Banks. Currently, he is a director of the West Rehoboth Land Trust in Rehoboth Beach and Meals on Wheels Lewes/Rehoboth, a member of the Beebe Healthcare Investment Committee, a trustee of a mutual fund complex and Vice Chairman of the Board of Directors at FHLBank Pittsburgh.

We are in a period of extraordinary change. From our new President to Brexit and economic policy – expecting the unexpected is becoming the norm. As new leadership takes over in Washington, there are already signs that the financial services industry may be in for major change. Against such a backdrop, Federal Home Loan Bank members can take heart that their co-op is ever-dependable.

Private Enterprise, Public Purpose

The Federal Home Loan Banks (FHLBanks) were created by Congress at the height of the Great Depression to ensure there would always be money for home mortgages. Although their mission and membership have expanded, housing has been at the heart of the FHLBanks for their 84-year history.

Interestingly enough, the FHLBanks aren't national and don't make home loans. Instead, they are regional co-ops, privately owned by their member financial institutions, all of which are involved in residential lending. As a government-sponsored enterprise (GSE), FHLBanks enjoy an implied government guarantee and advantageous treatment in the capital markets. But unlike the other housing GSEs – Fannie Mae and Freddie Mac – there is not one dime of government money in the FHLBanks.

The primary business of the FHLBanks is to intermediate between the capital markets and local financial institutions all across America. Generally this means FHLBanks make attractively priced collateralized loans, called advances, at favorable rates to their members. In turn, members are able to invest in housing and economic development, most often by offering mortgages and other loans to individuals and businesses in the communities they serve. In addition to their primary business of serving the credit needs of their members, FHLBanks also purchase mortgages, and they set aside 10 percent of their income for the Affordable Housing Program, which provides grants or subsidized loans through member institutions to help lower-income individuals and families.

Backed by a Strong System

Delaware bankers know that their FHLBank is a strong and powerful resource for their business. Yet beyond FHLBank Pittsburgh's 304 members and three-state footprint is a System that supports an entire nation of local lenders. I have experienced the FHLBank System over many years from many angles: member-user, debt-buyer, debt-issuer, director. My work at three member institutions, a Wall Street firm and especially the System's fiscal agent, the Office of Finance, gives me perspective to describe why the FHLBank System provides an indispensable advantage to America's financial institutions and the communities they serve.

The FHLBank System comprises the Office of Finance, the 11 individual FHLBanks* and their 7100+ members: banks, insurance companies, thrifts, credit unions and community development financial institutions. While each FHLBank operates independently with its own management and Board of Directors, unique characteristics of the System provide cohesion and strength as well as business benefits for the membership.

Key attributes of this cohesion and strength include ample capitalization, joint and several liability on System debt, implied government guarantee as a GSE and the highest credit rating that goes with it, professional securities dealers that underwrite System debt, effective relationships and cooperation among the 11 FHLBanks, and a strong regulator.

Of these key attributes, joint and several liability is perhaps the most distinctive. Simply, it means that if one FHLBank is ever unable to repay debt issued on its behalf, the other 10 would be required to step in. From my 16 years as CEO at the Office of Finance, I can attest to the power of this simple statement in the minds of investors, who appreciate that there's a $1 trillion System behind every debt instrument issued.

The final attribute is crucial. The FHLBanks have a strong regulator in the Federal Housing Finance Agency, which also regulates Fannie Mae and Freddie Mac. There's no doubt that a skilled professional regulator with robust processes and strong technical skills strengthens the System overall.

Conservative Management Built into a Cooperative Structure

Perhaps the most compelling single statement to be made about the FHLBanks is that they have never incurred a loss on an advance, not a single dollar. That's a big statement considering the many trillions of dollars that have flowed through the System over 84 years.

Because the FHLBanks are co-ops, their customers and owners are one and the same. As a result of this cooperative structure, conservative management is "baked in" in several important ways. First is the composition of the Boards of Directors. Each Board includes both member directors and independent directors, all elected by the membership, with member directors in the majority. Because of this, governance of the FHLBanks ties directly back to the membership.

The measurement of member value is also built into the cooperative structure. With a stock that is issued and redeemed at par, FHLBanks offer value through both attractive product pricing and a dividend, unlike companies that may focus on maximizing profits for their shareholders. The need to provide both attractive pricing and a reasonable return on investment results in a generally conservative risk appetite.

A third aspect of how structure drives conservative management is what I'll call built-in backstops. FHLBanks are self-capitalizing, and all loans are fully collateralized, primarily with single-family and multifamily loans. Members must purchase stock in proportion to the amount of business they do with their FHLBank. Thus, the Bank is self-capitalizing and can expand and contract according to the membership's borrowing needs. Additionally, every FHLBank member has a maximum borrowing capacity based on its assets. As long as the member has satisfactory capacity, it can rely on the Bank for on-demand liquidity. Each FHLBank can lend with confidence knowing that each and every loan is capitalized and has sufficient quality collateral behind it.

These three features – Board composition, a balance of pricing vs. dividend, and the built-in backstops of self-capitalization and collateralized lending – are inherent in the structure of each FHLBank and fundamental to the System's remarkable history of success.

Benefit to Members, Benefit to Communities

For Delaware bankers and every member of each FHLBank, a strong System translates into strategic business advantages. First and foremost, FHLBanks are always there – ready to lend to the extent each member's individual borrowing capacity permits. Next, and importantly, the presence of the Office of Finance in the global markets every single day results in advantaged debt issuance, which is passed along as attractive pricing on advances. Finally, dividends paid to members, particularly on activity stock, add to the value of membership and the attractiveness of all-in borrowing costs.

FHLBank Pittsburgh members typically cite access to liquidity as the number one advantage of membership. Whether they use the funding or just sleep better at night knowing they can, FHLBank Pittsburgh members – large and small – enjoy a strategic business advantage.

Advances are the main business of FHLBank Pittsburgh. They are used for various reasons by various members, the main one being liquidity, providing the ability to fund loans made in their communities. MidCoast Community Bank's CEO Eric Hoerner explains it like this. "As we make loans in the community, we focus on credit quality, not availability of funds. We can do this without worry because reliable, affordable funding is available, on demand, from FHLBank Pittsburgh."

(continued on p. 16)

**Historically, there were 12 FHLBanks until the Federal Home Loan Bank of Seattle merged into the Federal Home Loan Bank of Des Moines in 2015.*

(continued from p. 15)

FHLBank Pittsburgh also serves as a strategic business partner for members who originate mortgages but do not wish to retain them on their balance sheets. The Mortgage Partnership Finance® (MPF®) Program combines members' credit expertise and knowledge of their customers with FHLBank Pittsburgh's funding/hedging expertise to provide a profitable alternative for funding mortgages. The MPF Program was created in 1997 by the Federal Home Loan Bank of Chicago. Since then, the MPF Program has helped more than 1,200 financial institutions fund more than 1.3 million loans for families across America to purchase new homes or lower the cost of their existing homes. FHLBank Pittsburgh recently made favorable changes in its MPF Program that make it an increasingly valuable business tool, a silver lining in today's complex mortgage environment, especially when combined with the Program's pricing and ease of use.

Senator Chris Coons works with Central Delaware Habitat for Humanity in Dover to build eight new homes.

"Community Dividend"

FHLBank Pittsburgh offers a suite of products targeted to specific community needs: affordable housing, homeownership, job creation and retention, and community vitalization. These products are all funded by FHLBank Pittsburgh and delivered through member financial institutions. As tangible benefits of membership, they constitute a "community dividend."

The Affordable Housing Program (AHP), now in its 27th year, is the largest and best known of these products. FHLBank Pittsburgh has provided more than $17 million in AHP grants to Delaware members, creating more than 1,750 affordable housing units through 83 projects.

This past fall, I was delighted to attend a check presentation ceremony with Senator Carper in Wilmington where Habitat for Humanity of New Castle County celebrated a $160,000 AHP grant received through WSFS Bank for Phase 1 of their Walnut Ridge project, which includes four volunteer-built homes. In April, Senator Coons joined FHLBank Pittsburgh to highlight a $400,000 grant to Central Delaware Habitat for Humanity for eight new homes in Dover. These two projects, and many like them, illustrate why the FHLBank System is the largest corporate contributor to Habitat for Humanity in the United States.

Another example of AHP at work in Delaware was a $500,000 grant to the Todmorden Foundation, again through WSFS Bank, for Phase 1 of "The Flats" where 80 functionally obsolete units were replaced by 72 modern apartments on a historic property. I was pleased to join Senator Coons at the launch of this multiphase development, which will eventually become a 450-unit complex for low-income individuals, many with disabilities.

Without question, AHP is an enormous strength of the FHLBank System. All 11 FHLBanks conduct their own programs. Together, over AHP's 26-year history, they have pumped more than $4.7 billion into projects just like those described above, all through member institutions, to help subsidize nearly 788,000 housing units and forever change the lives of individuals and families.

While AHP's success is huge, nationwide and well known, a small initiative, unique to FHLBank Pittsburgh, is quietly changing communities, making them better places to live and work.

Blueprint Communities® provides training in leadership and capacity building, along with access to special funding opportunities, to help qualified communities rebuild and revitalize. Earlier this year, three Delaware communities joined the Blueprint family, bringing to nine the number of Delaware communities with the Blueprint Communities designation.

"West Side Grows" is an inspiring example of success in Wilmington. One of the original Delaware Blueprint Communities back in 2009, West Side Grows has capitalized on the training received through the initiative. Community gardens, renewal of blighted and vacant properties, encouragement of small business development and a plan to make it more "shopper friendly" have brought new momentum to the West Side. The Flats, noted above, is adjacent, adding new life as construction continues. Another FHLBank Pittsburgh product, Banking On Business, helped fund a new enterprise in the West Side. Popdot, LLC, provides actual jobs, not just training, for former foster youth who have aged out of the system.

I am gratified to see the success of Blueprint Communities in our state. As communities build capacity in leadership and sound local planning, they create a foundation for the future. Throughout the initiative's history, over and over we've seen how FHLBank Pittsburgh's collective investment multiplies into housing, jobs and improvements to quality of life.

Always There

The FHLBanks have performed reliably through all economic cycles, most notably at the start of the 2008 financial crisis when the FHLBank System was widely credited with keeping the U.S. financial system afloat. As the future of the financial services industry unfolds, whether in predictable or totally unexpected ways, the FHLBank System will be there to assure the flow of credit to support housing finance and community lending, and provide services that enhance members' business and vitalize their communities. Reliable, responsive, cost effective: it's a business model that works.

Groundbreaking for Phase 1 of The Flats with Senator Coons, May 2015. Multiphase development will eventually become a 450-unit complex for low-income individuals, many with disabilities.

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"Blueprint Communities" is a registered service mark of the Federal Home Loan Bank of Pittsburgh.

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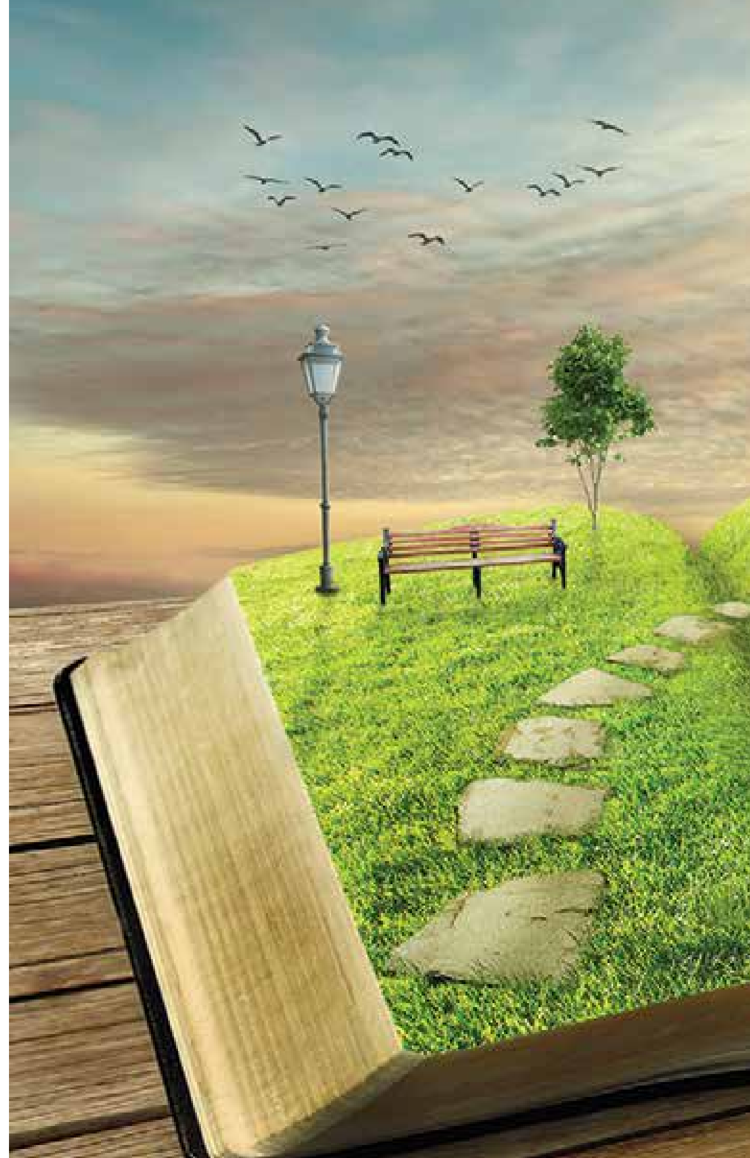
Trust and High Net Worth Team

Real Estate Professional: *Fact or Fiction?*

by
Robert Freed
Santora CPA Group



An individual taxpayer, when you incur real estate losses, you need to make a determination on whether those losses are fully deductible against your other ordinary income or will those losses be subject to limitations as to the amount of deductible loss.

What options are available to deduct real estate losses when, in addition to your regular business which has nothing to do with real estate, you have a number of rental real estate properties that are throwing off losses that you'd like to deduct against your other income for tax purposes? As most taxpayers who are involved in real estate know, the passive activity loss (PAL) rules would normally make this virtually impossible. Under those rules, losses from passive activities, that is, activities in which you do not "materially participate," as defined later, cannot be deducted against nonpassive activity income (such as salary, professional fees, income from a business in which you do materially participate, interest, or dividends); and credits from passive activities cannot

be used to reduce taxes on nonpassive activity income. For purposes of the PAL rules, rental real estate activities are automatically treated as passive activities, even if the owner "materially participates" in their management, operations, etc. As a result, tax losses from rental real estate activities can't be deducted against nonpassive income.

One important exception to this rule allows taxpayers to deduct up to $25,000 of losses and credits from passive rental real estate activities against nonpassive income, if they "actively participate" in those activities. Active participation requires a lesser degree of participation than "material participation." This exception phases out for taxpayers with adjusted gross income over $100,000. So you can see, there are very limited cases when the real estate loss would be fully deductible.

There's another exception to the above rule that's even more potentially beneficial than the $25,000 active participation rule just mentioned. If you qualify as a "real estate professional," your rental real estate interests are not automatically treated as passive activities. As a result, if you materially participate in the rental real estate activity, the activity will not be treated as passive, and you will be entitled to deduct losses from that activity against nonpassive income. In addition, the amount of losses and credits allowed under the $25,000 active participation rule is determined after any recharacterization of rental real estate activities as nonpassive under the rules discussed above. As a result, if you're a real estate professional, you can deduct against nonpassive income not only losses and credits from rental real estate that are nonpassive under the above rules, but up to $25,000 of losses and credits from "active participation" rental real estate activities that remain passive after the application of those rules.

So, the underlying question is this: *How do you qualify as a real estate professional?* First, you must materially participate in a real estate business. The business of renting and leasing property is a real estate business. Second, more than 50% of the personal services you perform in all businesses during the year must be performed in real estate businesses in which you materially participate. Third, your personal services in material participation, real property businesses during the year must amount to more than 750 hours. For these purposes, you can't count any work you perform in your capacity as an investor.

In determining whether you qualify as a real estate professional, each of your rental real estate interests is treated as a separate activity, that is, as a separate business, unless you make an election to treat all those interests as a single activity. Because of this rule, if you have multiple rental properties and you don't make the election, you must establish material participation for each property separately, and you must satisfy the more-than-50% test ***and*** the 750-hours test for each property separately in order to qualify as a real estate professional with respect to that property. Unfortunately, qualifying for one property wouldn't mean you qualify for any other property. Thus, if you don't make the election, qualifying as a real estate professional for all your properties becomes more difficult (and may become impossible) as the number of properties increases. But if you do make the election, you only have to establish material participation, and satisfy the more-than-50% test and the 750-hours test, for the combined properties as a whole.

You don't have to work full time in real estate to qualify as a real estate professional. Even if you have another occupation, you can qualify if you materially participate in a real estate business, and spend more time, and more than 750 hours, on that business. But remember, in this case, if you have multiple properties, it may be difficult or impossible to qualify unless you make the "single interest" election mentioned above.

(continued on p. 20)

Taxes

(continued from p. 19)

These tests are applied annually. This means that you may qualify as a real estate professional in some years but not in other years. As a result, the same real estate activity may generate passive losses in some years and nonpassive losses in other years.

If you're a real estate professional, *what more do you have to do to treat losses from rental real estate as nonpassive?* If you qualify as a real estate professional, your rental real estate properties are not automatically treated as passive.

This doesn't mean that they are automatically treated as nonpassive. It means that, if you materially participate, as explained below, in the operation of a rental real estate property, it will be treated as nonpassive, and you may deduct losses from that property against other nonpassive income.

But if the real estate business that qualifies you as a real estate professional is the renting or leasing of real property, as discussed above, you will already have established that you materially participate in that business-because if you don't, you can't qualify as a real estate professional on the basis of that business.

As previously mentioned, if you have multiple properties, you may not be able to qualify as a real estate professional unless you elect to treat all of your rental real estate interests as a single activity. If you make the election, it applies both for purposes of qualifying you as a real estate professional and for all other purposes of the PAL rules. And, generally speaking, the election is irrevocable. This means that you can't make the election in order to qualify as a real estate professional, and then revoke it with respect to a particular property later, when, for example, that property produces income, and you'd like to use that income to absorb losses from another non-real-estate-related passive activity. Making the election will also disqualify you from utilizing the $25,000 active participation rule mentioned above, because that rule applies only with respect to losses from rental real estate activities that are passive, and the election will presumably work to make your rental real estate properties nonpassive. If making the election is the right course for you, it is important to make sure that it is made in a timely and proper fashion.

What is material participation in an activity? Material participation in an activity means involvement in the operations of the activity on a regular, continuous, and substantial basis. If a taxpayer passes one of the following seven tests, the IRS accepts that as establishing material participation in an activity:

• Participating in the activity for more than 500 hours in the tax year (the most frequently utilized test);

• Participating in the activity if the taxpayer's participation is substantially all of the participation in that activity by any individuals (including non-owners);

• Participating in the activity for more than 100 hours in the tax year, if nobody else (including non-owners) participated more;

• Participating significantly in the activity, if participation in all "significant participation" activities for the tax year exceeds 500 hours (but this test isn't accepted for showing material participation in rental activities);

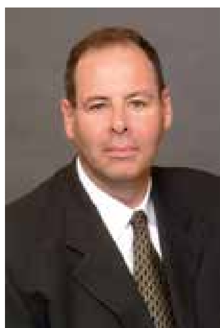
• Having materially participated in the activity during any five of the ten tax years preceding the year at issue;

• With respect to personal service activities, having materially participated in the activity for any three years (not necessarily consecutive) preceding the year at issue;

• Showing regular, continuous, and substantial participation on the basis of all the relevant facts and circumstances, but only if more than 100 hours of participation during the tax year can be shown (and management services aren't taken into account for purposes of this test unless certain stringent requirements are satisfied).

The extent of an individual's material participation in an activity may be established by any reasonable means. But the most reliable means of showing material participation consists of contemporaneously kept appointment books, calendars, daily time reports, logs, or similar documents that provide a detailed account of what the taxpayer did with respect to an activity, when he or she did it, and how much time it took. Failure to substantiate material participation is one of the most common ways of losing the right to treat rental real estate activities as nonpassive.

The real estate professional rules can be quite complex and tricky to navigate so meeting with a tax professional is critical to making sure the rules and tests are adhered to in order to properly maximize your tax deduction.



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For Your Benefit

Congress Clears Path for ACA Repeal

by
Louis D. Memmolo, GBA, CHRS
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"The executive order along with Congresses' budget bill will likely provide tools to implement some impactful changes to the ACA..."

On Jan. 13, 2017, the U.S. House of Representatives passed a budget resolution for FY 2017 to begin the process of repealing the Affordable Care Act (ACA). The budget resolution—which was approved by the U.S. Senate on the preceding day—does not, itself, repeal the ACA. However, any budget reconciliation bill drafted as a result of the resolution is likely to include a number of provisions to repeal—and possibly replace—at least some ACA provisions. House and Senate committees have targeted Jan. 27, 2017, as the deadline to draft the bill.

ACA provisions that may be affected include those that are enforced as tax such as:

The individual mandate which requires most individuals to obtain acceptable health insurance coverage for themselves and their family members or pay a penalty.

The employer shared responsibility rules requiring applicable large employers to offer an acceptable level of health coverage to full-time employees (and their dependents) or pay a penalty.

Federal Exchange subsidies for low-income individuals to help individuals and families purchase insurance through an Exchange. While these subsidies have long been a target for opponents of the ACA, it is unlikely that the budget reconciliation bill will include provisions affecting these subsidies without an adequate replacement.

President Trump's ACA Executive Order

On January 20, 2017, Donald J. Trump was inaugurated the 45th President of the United States. He has hit the ground running with a flurry of executive orders laying the groundwork to fulfill various campaign promises. One of which was his hallmark promise to repeal and replace the Affordable Care Act.

One of the first EO's signed begins, "It is the policy of my Administration to seek the prompt repeal of the Patient Protection and Affordable Care Act… pending such repeal", it then directs the Secretary, federal agencies and agency heads to ease the "regulatory burdens" of the ACA to the maximum extent of the law. It orders agencies to "waive, defer, grant exemptions from, or delay the implementation of any provision or requirement" of ObamaCare that imposes a "fiscal burden on any State or a cost, fee, tax, penalty, or regulatory burden on individuals, families, healthcare providers, health insurers, patients, recipients of healthcare services, purchasers of health insurance, or makers of medical devices, products, or medications."

The executive order along with Congresses' budget bill will likely provide tools to implement some impactful changes to the ACA while replacement ideas are debated.

While the news was preoccupied with the election results several other important legislative actions occurred.

21st Century Cures Act – New Stand-alone HRA Option for Eligible Small Employers

On Dec. 13, 2016, the 21st Century Cures Act (Act) was signed into law, which allows small employers that do not maintain group health plans to establish stand-alone HRAs. This new

type of HRA is called a "qualified small employer HRA" (or QSEHRA). The maximum benefit available under the QSEHRA for any year cannot exceed $4,950 (or $10,000 for QSEHRAs that also reimburse medical expenses of the employee's family members). The maximum dollar limits must be prorated for individuals who are not covered by the QSEHRA for the entire year.

For small employers that had terminated their group health plans and struggled with ways to reimburse their employees for health costs this will be an important new tool at their disposal.

ACA Section 1557 Non-Discrimination Rules blocked by Federal Court

On Dec. 31, 2016, the U.S. District Court for the Northern District of Texas issued a nationwide preliminary injunction temporarily blocking enforcement of the Section 1557 nondiscrimination rules under the ACA. Section 1557 is the first federal civil rights law to broadly prohibit discrimination on the basis of sex in federally-funded health programs.

The court's injunction specifically bans provisions prohibiting discrimination based on **gender identity** or **termination of pregnancy**.

In August 2016, five states and three Christian-affiliated health care groups filed a lawsuit challenging the final rule, arguing that the rule forces them to perform and provide insurance coverage for gender transition services and abortions against their religious beliefs and medical judgment; and violates the federal Administrative Procedures Act (APA), the Religious Freedom Restoration Act (RFRA) and certain protections in the U.S. Constitution.

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Compliance Focus

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"A culture of compliance is paramount to preventing internal fraud."

Internal Fraud in the Spotlight

The relationship between internal fraud and incentive programs dominated the spotlight in 2016. In June, several federal agencies published a joint notice of proposed rulemaking to establish incentive-based compensation requirements at covered institutions with at least $1 billion in total consolidated assets.

In September, the OCC and CFPB assessed a civil money penalty against a large U.S. financial institution, which also recently settled litigation related to the same issues. The settlement and fines stemmed from alleged unfair and abusive sales practices linked to the financial institution's incentive compensation program. In total, the institution paid more than $185 million in penalties, including a $100 million fine imposed by the CFPB – the largest in the agency's history.

In November, the CFPB issued a bulletin warning about the potential dangers that employee and service-provider incentive programs – including sales goals, benchmarking, performance-linked compensation and quotas – can create for consumers. The bulletin detailed possible unintended consequences of such incentive programs and made recommendations for how to monitor them and reduce risk.

Internal fraud covers a broad spectrum of inappropriate or unethical actions taken by internal stakeholders to receive a benefit at the expense of customers, investors or others within the company. Generally, actions that lead to internal fraud issues do not develop randomly or inside a vacuum. Organizational culture drives how people make decisions on a daily basis, and fraudulent decisions can usually be traced back to how an organization communicates its ethical guidelines and the level of engagement stakeholders have in relation to those guidelines.

In 2016, multiple financial services companies were cited with large penalties related to internal fraud. These penalties were derived from a multitude of areas, including alleged UDAAPs, opening unauthorized accounts, teller fraud, identity theft, money skimming and collusion with outsiders.

In addition to the direct impact of regulatory action against institutions for internal fraud, the side effects of internal fraud are also important to note. For example, reputation damage is common due to a change in a customers' perceptions of how reliable a financial institution is and whether it is fit to handle their business, resulting in both lost relationships and a decrease in new business.

A culture of compliance is paramount to preventing internal fraud. This starts with commitment from an institution's leadership. Compliance must be encouraged at all levels, and the system put in place should hold employees and leaders accountable for their actions. An institution must also have a code of conduct, a defined compliance plan and strong training and communication.

Some challenges for financial institutions related to internal fraud include:

- Protecting against pressure on employees to reach quotas
- Finding new ways to generate revenue without increasing internal fraud risks

- Ensuring adequate internal controls and checks and balances to mitigate risk
- Providing adequate and appropriate training for employees
- Navigating organizational complexity across multiple business units and third-party service providers
- Managing numerous, sophisticated technology tools available to employees

Institutions can use the internal fraud checklist below as a starting point for addressing these challenges. This is not an exhaustive list of things to consider.

❑ Conduct an internal fraud risk assessment

❑ Provide fraud awareness training to all officers and employees

❑ Enact effective reporting procedures and whistleblower protections

❑ Establish monitoring for internal fraud exposures, including reviews of high-risk activities throughout the organization and identification of red flags that indicate potential wrongdoing by internal stakeholders

❑ Implement a system for identifying anomalies in behavior indicative of fraud or the beginning of fraud and responding timely

❑ Perform a root-cause analysis to identify why internal fraud occurred and why it was not detected sooner

❑ Assess compensation policies and potential competitive pressures at all levels.

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n. fear of disorder or untidiness

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Accounting for Success

by
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"...Recognize the need for 'facetime' with others to listen and candidly share experiences."

Managing the Best Interests of Multiple Beneficiaries of Trusts

Trusts are set up for many different reasons and in many different forms, but no matter the reason they will always have at least one beneficiary. In some cases, they will have multiple beneficiaries which will usually consist of an income and a remainder beneficiary. These two beneficiaries, who are likely benefiting from the trust at different points in time, may disagree over the type of assets with which the trust invests. Income beneficiaries usually prefer assets that produce income (i.e., dividends, interest, royalties, etc.) while remainder beneficiaries are probably more concerned with the growth of the principal assets. Investment choices that do not align with both parties' interests or do not accurately reflect the intention of the trust documents could create potential disagreements in future years.

Trust fiduciary income, which is different than a trust's taxable income, is generally used to calculate the amounts that should be distributed currently to the income beneficiary while all other amounts are allocated to principal. The principal is subsequently distributed to the remainder beneficiary at some point in the future. The trust instrument is used to define which receipts should be allocated to each category of income. If the instrument is silent, local law dictates the category. Common examples of income allocations are interest and dividends, while sales proceeds from dispositions of property usually are considered principal. A common analogy is to think of a tree with fruit. The fruit is analogous to the income beneficiary while the tree belongs to the remainder beneficiary.

Correctly allocating receipts to income or principal is an important duty of the trustee since this allocation is used to determine the amount of annual distributions that the income beneficiary should receive. Making insufficient distributions to the income beneficiary will obviously make that beneficiary unhappy while giving too much would upset the remainder beneficiary.

One way for trustees to utilize investment options that benefit both beneficiaries is to utilize the 1997 Uniform Principal and Income Act. This Act gives trustees the power to make adjustments between principal and income for an overall total return concept. The total return concept focuses on getting the greatest total return from an investment portfolio whether it is through the growth of the asset or through annual income. The trustee has this power as long as the following three criteria are met:

1- The trustee manages the assets in accordance with the prudent investor rules,
2- The trust instrument describes the income beneficiary's rights in terms of fiduciary accounting income, and
3- The trustee is unable, without exercising the power to adjust, to administer the trust impartially or to achieve the degree of partiality required or permitted by the governing instrument.

Under the power to adjust concept, the trustee has discretionary power to transfer principal receipts to income or vice versa if the returns from the investment do not fairly benefit both types of beneficiaries. This power cannot be overturned by courts as long as the trustee did not abuse his fiduciary duty or use it solely for tax evasion purposes.

Another way of balancing distributions between each type of beneficiary is for the trust to adopt the unitrust concept. Under this concept, the accounting income is defined to be a fixed percentage of the net fair market value of the trust assets, recomputed each year. The IRS has approved the fixed percentage to be between 3 and 5 percent. This allows the trustee to invest in growth assets without consideration of whether it is producing current income or not. Since these growth assets may not generate annual income, the trustee could sell them off to pay out the annual fixed percentage.

It is very important for the trustee to read the trust document and to have a clear understanding of how the income should be calculated. If the trustee is unable to perform this calculation, they should appoint someone who has the appropriate knowledge. Failure to correctly calculate the income could cause unfair distributions to the income and the remainder beneficiaries. Finally, there may be other options available to the trustee that allow them to invest in assets to provide the best return for all parties.

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March 1st - 3rd, 2017
DBA 2017 Executive Officer Washington Visit

This highly acclaimed event for top-level bank executives provides an extraordinary opportunity to meet with the key federal regulators as well as with our industry's representatives at the American Bankers Association in Washington, DC. In addition, we also meet with the entire Delaware Congressional Delegation. This year, DBA participants will be staying at The Willard Hotel. Sponsorships Available!

April 24th through 28th, 2017
Teach Children to Save Day

This year's event, the 19th annual, will take place on Tuesday, April 25th, but classes will be available throughout the week (April 24th through April 28th). Teaching the lesson is fun and easy and no previous experience is necessary. A full teaching kit is provided along with on-line training (available April 1st). Banker Volunteers can begin registering on-line starting February 10th via www.debankers.com. This year's event will feature a new adventure with The Great Investo, the world's worst money magician. *The Great Investo and the Million Pennies* teaches the importance of establishing consistent saving habits. As Penny his assistant points out: "Every little bit you save, makes a little bit more!" Not willing to wait, Investo uses his dubious magical skills to save one penny a day for one million days, and finds himself over 2000 years in the future. The book, the seventh in the Great Investo series of children's books, is written and illustrated by Greg Koseluk and made possible by a grant from Capital One. *The Great Investo and the Million Pennies* will be available in mid-February.

May 18th, 2017
122nd Annual DBA Meeting & Dinner

Join Delaware's top bankers at this annual event at the historic Hotel du Pont with dinner in the elegant Gold Ballroom. Keynote speaker will be James Olson, Professor, George Bush School of Government and Public Service, former Chief of Counterintelligence at CIA headquarters in Langley, Virginia, and author of *Fair Play: The Moral Dilemmas of Spying*. Mr. Olson spent thirty years chasing Soviet KGB secrets, and jumping out of moving cars as a spy for the CIA. Don't miss this exciting and informative speaker! Sponsorships Available!

October 24th & 25th, 2017
2017 Delaware Trust Conference

Chase Center on the Riverfront, Wilmington. Save the date for the 12th annual edition of this premiere trust event highlighting the advantages of the Delaware trust product. Sponsors: join Platinum Sponsor, Reliance Trust Company of Delaware! Exhibitor space also available.

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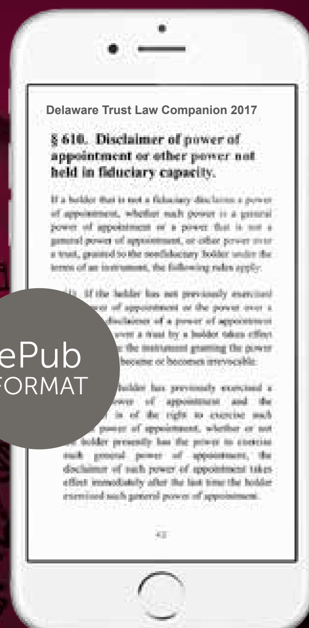

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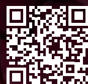
mnat.com  iTunes

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Lending Law Update

by
Cheryl Santaniello, Esq.
Young Conaway Stargatt & Taylor, LLP

"...lenders should be mindful that still requiring the execution of loan documents as an instrument under seal may have potentially beneficial legal significance..."

No Seal? No Problem.

Sealed Mortgage No Longer Required for Mortgage Foreclosure in Delaware Superior Court

Effective June 28, 2016, Section 2101(b), Tile 25 of the Delaware Code was amended. The amendment applies to any foreclosure proceeding filed on or after that date, regardless of the date on which a mortgage was signed, and eliminates the requirement that a mortgage be made under seal to be enforceable at law through a *scire facias sur* mortgage action commenced in Superior Court. Prior to such amendment, it was well-established that only sealed mortgages could be foreclosed at law, and lenders holding mortgages without seals had to pursue equitable foreclosure actions in Chancery Court. See *Monroe Park v. Metropolitan Life Ins. Co.*, 457 A.2d 734, 736 (Del. 1983) ("it is well settled that unless the seal requirement is abolished by statute, a mortgage must be under seal to be enforceable at law").

Section 2101(b) of Title 25, as amended, now reads as follows:

> A mortgage in the above form duly executed, acknowledged and recorded shall operate and be effective as a valid mortgage lien upon the entire interest of the mortgagors in the premises therein described, ***and irrespective of whether the mortgage is under seal***, it may be foreclosed in the Superior Court pursuant to Chapter 49 of Title 10.

[Emphasis added]. This change is significant for lenders. Equitable foreclosures in Chancery Court are an expensive and time-consuming process which, among other significant procedural hurdles, subjecting a foreclosing lender to a defending mortgagee's equitable defenses and counterclaims. In contrast, a *scire facias sur* mortgage action commenced at law in Superior Court is an action against the property itself that provides a lender with the legal remedy to obtain title to the mortgaged premises following the borrower's breach of the mortgage by nonpayment or nonperformance. *See* 10 Del. C. § 5061(a). The *scire facias sur* mortgage action is an expedited process and requires the mortgagor "appear and show cause why the mortgaged premises should not be seized and taken in execution for payment of the mortgage money and damages." *Gordy v. Preform Bldg. Components, Inc.*, 310 A.2d 893, 896 (Del. Super. 1973).

For a successful *scire facias sur* mortgage foreclosure, the lender typically only needs to show it holds the mortgage and that the mortgagor has failed to fulfill its obligation under the mortgage. *See* 10 Del.C. § 5061. A defaulting borrower's defenses to a *scire facias sur* mortgage proceeding are limited by Delaware law, and the defaulting borrower's counterclaims must typically be pursued in a separate proceeding rather than as part of the *scire facias sur* mortgage proceeding.

Although failing to require a seal on a mortgage no longer has legal significance impacting the type of foreclosure proceeding, lenders should be mindful that still requiring the execution of loan documents as an instrument under seal may have potentially beneficial legal significance in Delaware and other jurisdictions, including extending the statute of limitations within which the lender must file to enforce a breach. Legal counsel for the applicable state should be consulted on the significance of executing a particular document "under seal".

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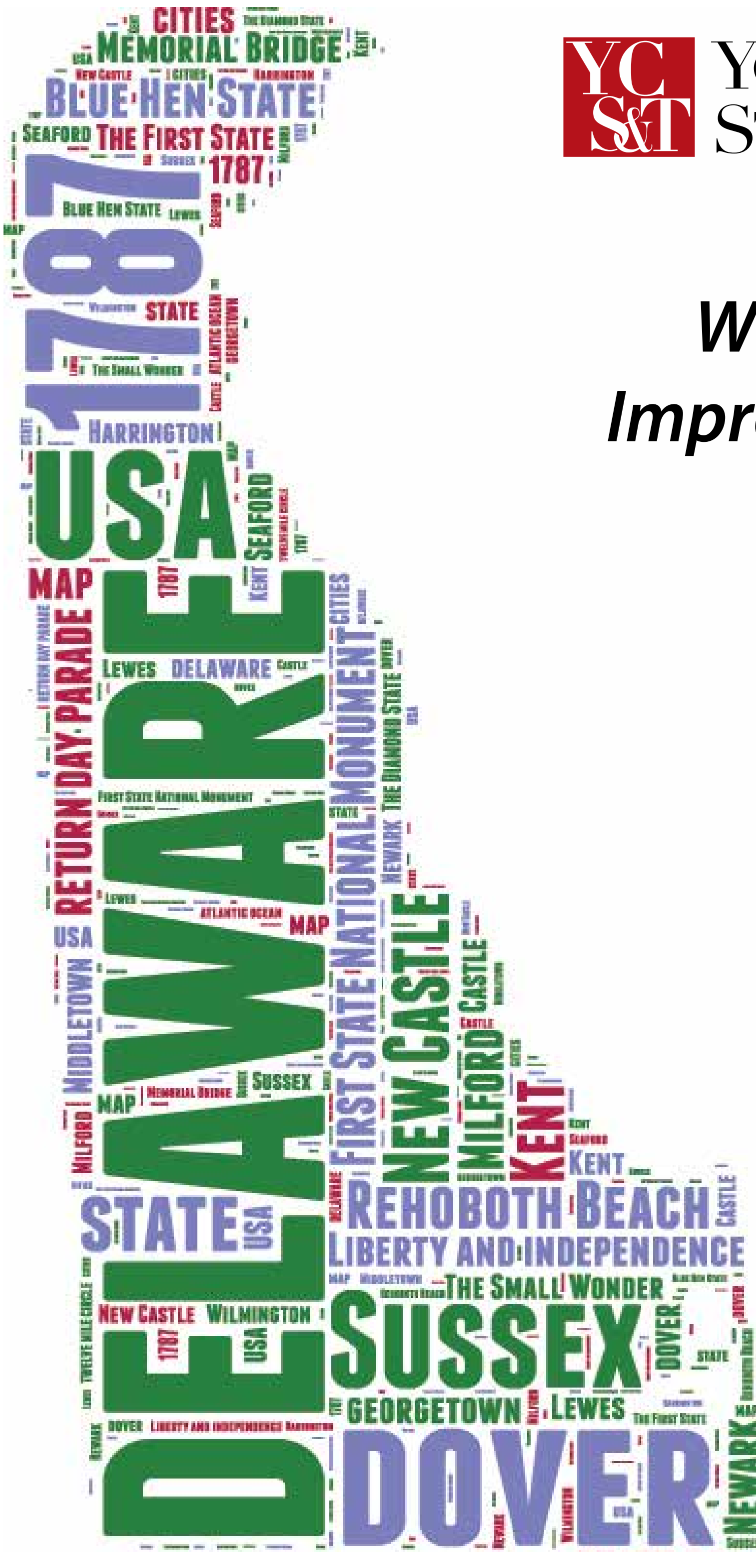

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