Legal Ramifications of Operation Choke Point

By Peter Weinstock, Hunton & Williams LLP[1]

I. Background

The U.S. Department of Justice ("DOJ") created Operation Choke Point ostensibly to combat consumer fraud.[2] However, it has become apparent that the program instead seeks to eradicate disfavored businesses. To do so, the program uses aspects of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")[3] to threaten injunctions and civil penalties against banks that provide access to the payment system for certain merchants and third-party payment processors ("TPPPs") to whom they provide services. Without access to the banking and payments system, these entities are unlikely to be able to continue operating.[4] This was precisely the DOJ's goal from the outset.[5] Banks are disassociating with customers engaged in lawful behavior, not simply customers whose activities may be fraudulent, as bankers try to define the next targets of the DOJ's efforts. The DOJ even acknowledged the prospects for such parties' banking relationships to be collateral damage of the DOJ's initiative.[6]

With Operation Choke Point, the DOJ is starting from the premise that certain lines of business or industries are anathema and then working backward to try to find legal violations. Using Section 951 of FIRREA to implement Operation Choke Point, the Government can issue subpoenas, take depositions, and seek civil damages against entities committing mail or wire fraud "affecting a federally insured financial institution."[7] In doing so, the DOJ need only meet the lower, civil evidentiary burden of proof ("by a preponderance of the evidence") to demonstrate fraud.[8] The DOJ's objective, however, is not to bring any action against those suspected of committing fraud, but to cause a bank "to scrutinize their account relationships and, if warranted, to terminate fraud-tainted processors and merchants."[9] Over the bank's head, the

[1] Peter Weinstock is a partner in Hunton & Williams's Dallas office whose practice focuses on corporate and regulatory representation of financial institution franchises. This written statement presents the views of Mr. Weinstock and does not necessarily reflect those of Hunton & Williams or its clients. The information presented is for general information and education purposes. No legal advice is intended to be conveyed. Mr. Weinstock may be reached at (214) 468-3395 or pweinstock@hunton.com.

[2] DARRELL ISSA, THE DEPARTMENT OF JUSTICE'S "OPERATION CHOKE POINT": ILLEGALLY CHOKING OFF LEGITIMATE BUSINESSES? (U.S. House of Representatives Committee on Oversight and Government Reform, 2014) at 2 (citing Letter from Peter J. Kadzik, Principal Deputy Assistant Attorney General, Office of Legis. Affairs, U.S. Dep't of Justice, to Rep. Blaine Luetkemeyer (Sept. 12, 2013) (stating "[t]he Department seeks to combat fraud and other unlawful practices in the payment system, and our efforts are focused on all those engaged in illegal activity."); Congressional staff briefing with the Deputy Assistant Attorney General for Consumer Protection, Civil Div., U.S. Dep't of Justice, on Sept. 20, 2013).

[3] Codified under 12 U.S.C.A. § 1833a.

[4] Issa at 1.

[5] *See generally* Nov. 5, 2012 Letter from Joel M. Sweet to Stuart F. Delery, Acting Assistant Attorney General (Civil Division) (HOGR-3PPP000020).

[6] *See, e.g.,* Nov. 5, 2012 Letter from Joel M. Sweet to Stuart F. Delery, Acting Assistant Attorney General (Civil Division), at 2-3 (HOGR-3PPP000020).

[7] *See* 12 U.S.C.A. § 1833a(a), (c).

[8] *See* Allyson Baker & Andrew Olmen, *FIRREA: The DOJ's Expansive (and Expensive) Tool of Choice*, 28 No. 10 Westlaw Journal Delaware Corporate at 1 (2013).

[9] *See, e.g.,* Nov. 5, 2012 Letter from Joel M. Sweet to Stuart F. Delery, Acting Assistant Attorney General (Civil Division), at 3 (HOGR-3PPP000020).

DOJ holds FIRREA's expansive reach, lower burden of proof, heavy monetary penalties, and ten-year statute of limitations.[10]

As a result of the DOJ's use of FIRREA, banks have been forced to choose between, at a minimum, incurring significant discovery and compliance costs and potentially accepting costly penalties, on one hand, or terminating existing relationships with TPPPs and other merchants that may be operating lawfully, on the other hand. The DOJ has calculated that banks' sensitivity to the costs of responding to the DOJ's inquiry, let alone to "civil/criminal liability and regulatory action," will cause a bank "to scrutinize immediately its relationships with [TPPPs] and fraudulent merchants and . . . take necessary action [*i.e.*, cut them off]."[11] In Operation Choke Point, the determination of whether a merchant is fraudulent is determined by the DOJ based on a line of business, rather than by an adjudication where those who are accused are afforded due process. The DOJ believes that "[l]egitimate banks will become aware of perhaps unrecognized risks and corrupt banks will be exposed."[12] In other words, a bank that does not agree with the DOJ's assessment, perhaps based only on return rates—which the DOJ concedes is only a "red flag of ***potential*** fraud"—will be deemed "corrupt" and subject to legal action.[13] Operation Choke Point has had a chilling effect on banks' ability to transact with such TPPPs and merchants where the reward cannot compensate for the potentially enormous costs and potential exposure under the DOJ's use of FIRREA. Banks are forced to drop these entities, but the affected TPPPs and merchants have no recourse to combat this penalty. It effectively becomes an extra-judicial permanent injunction by the agreement of government lawyers and an (appropriately) skittish bank.

In stating that its goal is to "positively sensitize the banking industry to third-party payment processor risk,"[14] the DOJ is launching an offensive against TPPPs and classically using enforcement to regulate, if not legislate away, organizations that may very well be legitimate. Such an approach is the province of rule-making under statutory authority with appropriate notice and opportunity to comment, and potentially, to challenge the adoption of the rule. This broad expansion of FIRREA triggers concerns that the DOJ has exceeded its authority under the statute or, if it has not done so, that the statute has no outer limit and is thus vague.

II. Flaws in the DOJ's Approach

FIRREA was passed in response to the Savings and Loan crisis of the late 1980s in part to curb "outright fraud and insider abuse" committed against depository institutions.[15] Through FIRREA, Congress aimed to protect depositors in financial institutions and federal taxpayers from fraudulent conduct that could result in a taxpayer-funded bailout.[16] With the federal government's current analysis, that intent is turned on its head. Instead of using FIRREA to protect banks from fraud, the DOJ is prosecuting banks for conducting disfavored business and then using discovery, including a draconian subpoena power, to try to find activity that can be

[10] 12 U.S.C.A. § 1833a(h).

[11] Nov. 5, 2012 Letter from Joel M. Sweet to Stuart F. Delery, Acting Assistant Attorney General (Civil Division), at 2-3 (HOGR-3PPP000020).

[12] *Id.* at 3.

[13] *Id.* at 2-3 (emphasis added).

[14] *Id.* at 3.

[15] *See* Issa at 3.

[16] *Id.* at 455.

deemed illegal. Entities shut out of one bank have little hope of establishing a subsequent banking relationship and will become defunct without any opportunity to defend themselves. While I am not championing the efficacy of payday lending, there are undoubtedly some organizations that operate lawfully and provide unbanked customers with a service such customers believe is valuable, one less dangerous than engaging a loan shark.

Indeed, a review of the development of Operation Choke Point reveals this new technique. As noted by the House Committee on Oversight and Government Reform, "internal memoranda on Operation Choke Point clearly demonstrate that the [DOJ's] primary target is the short-term lending industry. . . ."[17] Brandishing FIRREA as a sword, the DOJ chose to go after a number of banks that were doing business with TPPPs to get them to cease providing services to these entities. There was no proof when such decision was made that any of these banks were affected by fraud. Instead, in designing Operation Choke Point, the DOJ stunningly proposed identifying ten "suspect" banks for analyzing return rate data, among other "criteria."[18] However, the DOJ's "standards" for identifying fraudulent activities were arbitrary and relied almost exclusively on NACHA average return rate instead of potential violations of state—not federal—consumer protection laws.

NACHA is a private trade organization that administers and facilitates private-sector operating rules for ACH payments, which define the roles and responsibilities of financial institutions and other ACH Network participants.[19] The DOJ has alleged that an overall return rate of 3% on all of a merchant's ACH transactions should be the benchmark for what is considered fraud, because it is higher than the industry average tracked by NACHA. This is misleading. The overall return rate does not distinguish among the type of the return (unauthorized entries are very different from returns due to insufficient funds) or the nature of the transaction or customer base. Thus, the DOJ is not distinguishing between unauthorized return rates and returns due to insufficient funds. Furthermore, the DOJ compares the card networks' rate of disputed transactions to the overall ACH return rates, even though those are two completely disparate numbers. Card network disputed rates do not include transactions that are declined when the card is swiped. ACH returns, on the other hand, can include cases of insufficient funds or incorrect account information, along with debits disputed by the accountholder. The test employed by the DOJ to catch fraud may have resulted in legal businesses being considered fraudulent, too. It certainly resulted in dozens of banks and TPPPs receiving subpoenas. Accordingly, under the standards the DOJ is promulgating, it may advise a bank that a TPPP is engaged in fraud, ignoring legitimate reasons for a relatively high return rate, and expect the bank to terminate the relationship or incur significant discovery costs.

The DOJ has not commented on why it failed to take into account the long-standing relationships between the banks and the TPPPs, the previous reviews of the banks and TPPPs conducted by examiners, and the Treasury Department determination that TPPPs are not money transmitters and are not required to register with FinCEN. The DOJ's proposed use of mathematical proxies to allege fraud is a frightening prospect and far afield from what most federal prosecutors do

[17] Issa at 5.

[18] *See* Nov. 5, 2012 Letter from Joel M. Sweet to Stuart F. Delery, Acting Assistant Attorney General (Civil Division), at 4 (HOGR-3PPP000020).

[19] *See About NACHA*, accessible at https://www.nacha.org/about.

before bringing a fraud case. This type of activity has the potential to erode confidence in the DOJ.

The "chilling effect" of Operation Choke Point is not limited to the DOJ's actions. Instead, it is partially predicated on the notion that "reputational risk" arises when banks transact with TPPPs and certain "high-risk" merchants.[20] What constitutes "reputational risk," however, is not clearly defined. The Federal Deposit Insurance Corporation ("FDIC") issued a Financial Institution Letter entitled "Guidance for Managing Third Party Risk" that explains reputation risk as "the risk arising from negative public opinion" and adds "any negative publicity involving the third party, whether or not the publicity is related to the institution's use of the third party, could result in reputation risk."[21] Federal Reserve Board Governor Sarah Raskin explained "reputational risk" in a speech by stating that "enterprise value comes from intangible assets such as brand recognition and customer loyalty that may not appear on the balance sheet but are nevertheless critical to the bank's success."[22] Raskin further added that supervision of banks is necessary in order to prevent the accumulation of reputational risk to the extent that it constitutes a hidden exposure.[23] These comments illuminate the vague and subjective standard now being wielded by the federal government against banks doing business with disfavored industries. The "guidance" plainly does not distinguish between lawful and fraudulent activity. Reputational risk is not legal risk. Regulatory authorities proffer no standard of how to evaluate whether, as Raskin states it, that reputation risk is "accumulating" and that any "exposure" is material to safety and soundness.

Moreover, the Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System issued guidance in the fourth quarter of 2013 emphasizing the need for bankers to risk assess their customer base.[24] High-risk businesses require more extensive oversight, including potentially third-party testing of such parties' compliance management systems ("CMS"). To further define such businesses that may give rise to reputational risk, the FDIC published an article on its website.[25] This article sets forth 30 merchant categories that are deemed to be "high risk" in nature. Examiners, and thus bankers, are using this list as a touchstone informing what business relationships are disfavored. However, the list of merchant categories included seems somewhat arbitrary. Other merchant categories possibly could present higher risk to banks, but are not included. Examples of potentially high risk businesses not included on the FDIC's list include phone companies, financial advisors, personal trainers and tax preparation firms. Nevertheless, bankers have been relying on the FDIC list when determining with which firms to transact business.

[20] *See* Issa at 1.

[21] *See* "Guidance for Managing Third Party Risk." FDIC, Financial Institution Letter: Guidance for Managing Third Party Risk, FIL-44-2008 (June 6, 2008).

[22] *See* Sarah Bloom Raskin, Federal Reserve Board Governor, Address to the 2013 Banking Outlook Conference at the Federal Reserve Bank of Atlanta (Feb. 28, 2013).

[23] *See id*.

[24] *See* "Guidance on Managing Outsourcing Risk." Board of Governors of the Federal Reserve System, SR 13-19/CA 13-21 (Dec. 5, 2013); "Risk Management Guidance." OCC Bulletin 2013-29 (Oct. 30, 2013).

[25] *See* FDIC Supervisory Insights – Summer 2011, *Managing Risks in Third-Party Payment Processor Relationships*, accessible at http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum11/managing.html.

All of the guidance and the article regarding the "reputational risk" standard and high risk enterprises were promulgated without the requisite notice and comment period and without any administrative record. The nature of this new approach to knowing your customer goes well beyond the mandates of the Bank Secrecy Act and the Anti-Money Laundering laws and the US PATRIOT Act. While those statutes focus on potential money laundering and financial fraud, the new focus is potentially much broader, requiring banks to police their customers' CMS.

III. Effects of the DOJ's Overreach

With the expansion of Operation Choke Point, many banks simply are ceasing to provide services to TPPPs or high-risk merchants. The result is that TPPPs and other merchants labeled "high risk" no longer have access to deposit systems from regulated financial institutions. Without this access, these businesses may be forced to shut down.[26] Small and mid-size businesses who use TPPPs will no longer have an economical option for processing payments. These businesses rely upon TPPPs, because costs are prohibitively high to establish electronic systems to access the banking system and go through a bank directly. In fact, the vast majority of payroll in this country and the tax payments for payroll are performed by TPPPs. Shutting down TPPPs will upend this method of doing business. Currently, TPPPs and their merchant customers are looking to adopt bank-like levels of CMS. The costs of such compliance must be paid. In short, among other flaws, Operation Choke Point threatens electronic access to the banking system or risks imposing costs on small businesses, both of which are crucial components of the economy.

IV. Conclusion

Operation Choke Point represents a fundamental shift in law enforcement and regulation. The DOJ is using an obscure section of FIRREA intended to address those who caused losses to savings associations to justify imposing legal and regulatory pressure on banks serving disfavored businesses. As a result of Operation Choke Point, banks are forced to deny services to these disfavored entities or risk heavy civil penalties, criminal liability or regulatory action, even without any evidence that the banks have done anything wrong. TPPPs, in particular, have been targeted by the DOJ through these "back door" means. The DOJ is accomplishing its goal, but at what costs to the business community and consumers?

[26] If they seek to survive, these entities must turn to non-traditional sources of credit, which come with a very high risk and little regulation.