UNITED STATES OF AMERICA
BEFORE THE NATIONAL CREDIT UNION ADMINISTRATION

In the Matter of

Cascade Federal Credit Union *Docket BD-06-10*

Insurance Claim

Decision and Order on Appeal

Decision

This matter comes before the National Credit Union Administration Board (Board) pursuant to 12 CFR §745.202 as an administrative appeal of the determination by the Agent for the Liquidating Agent of St. Paul Croatian Federal Credit Union (FCU) denying the insurance claim submitted by Cascade Federal Credit Union.

Background

NCUA placed St. Paul Croatian FCU (FCU) into conservatorship on April 23, 2010, following the discovery of fraud, in the form of fictitious loans and other manipulation of the records, allegedly perpetrated by the FCU's CEO. On April 30th, one week later, the NCUA Board determined, given the scope of fraud, that conservatorship was not a viable option and placed the FCU into involuntary liquidation.

Through a letter, NCUA notified members of the conservatorship and imposed a share withdrawal limit of $5,000 per week, with a proviso for exceptions on a case-by-case basis. This letter, signed by the Region III Director and Agent for the Conservator (Agent), dated April 26, 2010, was posted in the FCU's lobby and on its website, and versions in English and Croatian were distributed to members who visited the FCU's two locations. The Agent determined it was necessary to institute a share withdrawal restriction because the fraud extended to the FCU's deposit records, such as forged share pledge documents used in lending. In addition, law enforcement suspected that accounts had been used for money laundering. The letter stated as follows:

> As conservator, our first task is to gain control of the business, including sorting out the share and loan records and conducting an investigation into the circumstances that led up to the appointment of the conservator. Accordingly, beginning immediately and extending for an indefinite time, the conservator has imposed a limit of $5,000 per week on the amount

> that may be withdrawn from member share accounts. On a case by case basis, the conservator will consider requests for an exception to this policy, for example in the event of an emergency or to meet a previously established commitment such as a home purchase. Members should also note that the application of this policy will not have any impact on the amount of share insurance that is available from the *[National Credit Union Share Insurance Fund]* NCUSIF to cover the funds in the account.

Claim

Cascade FCU (Appellant), located in Kent, Washington, invested $500,000 in a share certificate (account 2502000700) offered by the FCU on February 11, 2010. Appellant requested and obtained, as a condition of its making the investment, a waiver from the FCU of any penalty for early withdrawal in the event the FCU's financial condition deteriorated below specified criteria. After learning of the conservatorship, Appellant contacted the Agent and requested a withdrawal of the uninsured portion of the account. Appellant followed up the request in writing, by letter dated and faxed to the Agent on April 27, 2010.

The withdrawal request was not honored because of the share withdrawal restriction, which left approximately half of Appellant's account exposed to loss when the FCU was placed into liquidation on April 30. On June 24, 2010, NCUA's Asset Management and Assistance Center (AMAC)[1] determined that only $250,000 of the account balance was insured. This amount was paid out to Appellant. AMAC also provided Appellant with a certificate of claim for $250,916.44 in uninsured shares (which included a month's accrued dividend on the account).

On June 17, 2010,[2] the Board received Appellant's appeal, which seeks reconsideration and asks that the agency pay out the full balance in the account, $250,916. Under NCUA's regulations, the failure of the NCUA Board to issue a determination on an insurance appeal within 180 days of receipt of the appeal is deemed a denial of the appeal, with attendant rights to pursue judicial review of the final decision. 12 CFR §§745.202(d)(4), 745.203. Because the agency required additional time to review Appellant's claim, the Board and Appellant agreed to extend the Board's determination period until February 27, 2011.

Argument

Appellant requests a "deposit balance exception" because it engaged in proactive risk management when depositing funds in excess of share insurance limits by implementing an early withdrawal agreement contingent on negative financial trends. Appellant states it relied on the NCUA-supplied, quarterly 5300 reports when regularly

[1] References to AMAC throughout this decision refer to AMAC staff acting in their capacity as agents for the liquidating agent.
[2] We note that Appellant filed an appeal before receiving AMAC's official insurance determination, dated June 24, 2010.

reviewing the FCU's financial data. It asserts that NCUA failed to ensure the accuracy of the 5300 reports and failed to detect the fraud through its examination procedures.

Appellant argues that its decision to invest in the FCU was rational, thoroughly researched and conservative. It frequently makes investments in the shares of other credit unions but does so only after appropriate due diligence showing that the institution in which the investment is to be made is in sound financial condition. It only places funds with a credit union after it reviews and evaluates the applicable financial indicators, including the form 5300s that are filed with the NCUA. Appellant notes that the FCU reported its equity position at approximately 12% in its 3rd quarter 2009 filing and reported minimal loan delinquency. Appellant states its letter agreement concerning early withdrawal is further evidence of its rational, good faith investment decision.

Appellant also asserts that its loss is directly attributable to NCUA's failure to discover the fraud at the FCU. It alleges that the fraud, which had gone on for several years, should have been discovered earlier by NCUA's examiners, before Appellant made its investment. Appellant states it performed the requisite due diligence before making its investment, taking adequate, reasonable steps to ensure that it would not lose money, but that it was victimized by fraud that NCUA should have discovered and corrected.

Discussion

NCUA's rules governing share insurance provide that accounts of a corporation engaged in any independent activity shall be insured up to $250,000 in the aggregate. 12 C.F.R. §745.6. Appellant is a federal credit union, organized and chartered under the Federal Credit Union Act (FCU Act). It invested in the FCU under its authority to invest in the shares or share certificates of federally-insured credit unions. 12 U.S.C. §1757(7)(H). AMAC correctly determined that Appellant's account was insured up to $250,000 in the aggregate and that, upon the FCU's liquidation, the remaining balance in its account was uninsured.

Duty of NCUA as a Regulator to Detect Fraud

NCUA does not bear liability to Appellant for failing to detect the fraud that led to the FCU's insolvency. The FCU Act states unambiguously that an FCU is under the supervision of the NCUA Board and shall make financial reports to the agency as well as make its books and records accessible to NCUA for purposes of examination. 12 U.S.C. §1756. Federal law provides similar authority for the other banking regulators, including the OCC and Federal Reserve. "These examinations, including examinations of credit unions by the Bureau [of Federal Credit Unions], are made for the purpose of supplying the Comptroller or the Director . . . with information necessary to perform his regulatory function. They are not made as a service to the bank or the credit union. The detection of fraud is not a primary function of the examinations . . . ." *Soc. Sec. Admin. Baltimore Fed. Credit Union v. United States,* 138 F. Supp. 639, 646 (D. Md. 1959). While the FCU plaintiff in *Social Security Administration Baltimore FCU v. United*

States alleged that examiners were negligent in performing examinations and failing to discover embezzlements, the district court found that the FCU Act did not impose upon the government a duty to the FCU to verify its accounts and records. "Of course, if a defalcation is discovered or suspected in the course of a Comptroller's or Bureau examination, the facts should be communicated to the proper officials . . .unless . . .the Director decides that more drastic action is necessary, such as closing the credit union altogether. . . . Such communication is made in the exercise of the regulatory function, not because the statute imposes any duty" to do so. *Id.*

In a bank fraud case, an appellate court determined that nothing in the Federal Deposit Insurance Act establishes a duty that the FDIC warn a bank of the unlawful banking practices of its officials. *First State Bank of Hudson County v. United States*, 599 F.2d 558 (3rd Cir. 1979). "If bank examinations by the FDIC reveal any irregularities or fraud, such examinations, though they may inure incidentally to the benefit of a bank, are intended primarily for the protection of the insurance fund." *Id. at* 563. "As long as the FDIC did no more than carry out its statutory responsibility to examine the Bank for insurance purposes, neither the FDIC nor the Bank could reasonably have believed that the agency assumed a duty to warn the Bank's board of the derelictions of their president and employee." *Id. at* 565. *See also Harmsen v. Smith,* 586 F. 2d 156 (9th Cir. 1978) *and In re Franklin Nat'l Bank Sec. Litigation,* 478 F. Supp 210 ("the Comptroller's primary duty is to supervise the banking system for the protection of the public and the national economy as a whole and not for the protection of an individual banking institution.").

In *Sisters of the Presentation of the Blessed Virgin Mary of Aberdeen v. NCUA,* a nonmember charity obtained shares in a low-income credit union well in excess of the applicable insurance limits when it was induced by credit union officials who were engaged in a fraudulent share certificate operation. 961 F.2d 733 (8th Cir. 1992). The officials represented the share certificates were collateralized by government securities and engaged in the fraud for several years. When NCUA liquidated the FCU, the charity held certificates totaling $2.45 million dollars. The charity argued it was entitled to priority preference by virtue of equitable trust principles because it was "induced by fraud to purchase the share certificates in Franklin and because NCUA was negligent in performing its duty to discover that fraud." *Id. at* 737. The charity also asserted it suffered unique harm in comparison to the other depositors by virtue of the amount of its loss. The court determined the charity was properly classified to the amount of its uninsured shares and not entitled to a constructive trust.

> First, it has been held that the regulatory activities of a government agency do not give rise to a duty to discover and report possible fraud or wrongdoing. . . . The NCUA was under no duty to discover or warn Franklin shareholders of fraudulent activities, and the Petitioner has no equitable claim based on regulatory negligence.
>
> Second, the Petitioner fails to establish that it was the only accountholder of the credit union that was fraudulently induced to purchase share

> certificates in excess of applicable insurance coverage. Nor did Petitioner suffer a fraud unique from other accountholders by Franklin's assurances that its certificates would be collateralized. . . .
>
> Finally, there is no equitable basis for the Petitioner's argument that it deserves priority over other accountholders because it stands to suffer the most substantial loss. We simply can find no basis in equity for giving the Petitioner a disproportionate advantage over other Franklin shareholders who also suffered losses.

Id. at 737-738.

Under the law, therefore, the regulatory authority that conducts examinations of insured depository institutions owes no legal duty to the institution or to its officers, directors, depositors or creditors. Accordingly, NCUA's alleged failure to discover the fraud at the FCU does not create a legal obligation on the part of NCUA to indemnify the Appellant against its loss.

Appellant's Reliance on False Financial Statements

In *Downriver Cmty. Fed. Credit Union v. Penn Square Bank,* 140 credit unions, along with dozens of other financial institutions, held substantial uninsured deposits in Penn Square, due to misrepresentations by the bank and a money broker. 879 F.2d 754 (10th Cir. 1989). The Court of Appeals overturned the district court's imposition of a constructive trust in favor of the credit unions. "A national bank's fraudulent conduct may give rise to a constructive trust only when the plaintiff can show that the bank's fraud caused a particular harm that is not shared by substantially all other depositors, and that granting relief to the plaintiff does not disrupt the orderly administration of the receiver's estate." *Id. at* 762. "Permitting recovery to the plaintiffs because they could prove reliance upon the financial statements, to the detriment of other uninsured depositors who could not or did not come forward to prove reliance upon PSB financial statements, fails to accord equal treatment to PSB creditors." *Id. at* 763.

> Although the plaintiffs contend that we might avoid this unequal treatment by permitting all depositors situated similarly to the plaintiffs to sue as a class to establish constructive trusts, to allow such suits would potentially jeopardize the orderly administration of the receiver's estate that is required by the Act. We do not think that Congress would have intended to deluge FDIC with the potentially crushing weight of claims for preferences on behalf of all the uninsured depositors who allege that they relied upon misleading information available to all depositors. Allowing such a preference to be based upon a "race to diligence" among creditors would make the "'equality promised to them by the [National Bank Act]. . . a mere mockery.'"

Id. at 764.

Like the plaintiffs in the cases above, Appellant is a sophisticated institutional accountholder that purchased share certificates based on unreliable financial statements. It did not suffer a unique harm compared to the FCU's other uninsured accountholders because of its reliance on financial statements, its acquisition of a waiver of withdrawal penalties, or as a result of the fraud allegedly perpetrated by the FCU's CEO. To establish a different class of accountholders or constructive trust[3] for its benefit would result in an inequitable distribution of the estate.

Consistent with Prior Decisions

In addition to the *Sisters of the Presentation* decision, the NCUA Board has denied appeals from members who suffered losses caused by fraud perpetrated by credit union management, including other claims arising from the liquidation of St. Paul. *See* NCUA Docket BD-24-10 and NCUA Docket BD-06-05.[4]

We also note, that in a decision to deny a claim for uninsured shares submitted by an FCU, the Board stated that "[a]s an institution accepting deposits from its members subject to NCUA's share insurance regulations, Appellant should be should be aware of the limitations on insurance coverage." NCUA 98-INS-005.

Conclusion

As discussed above, an account of a corporation may be insured up to no more than $250,000 under Section 745.6.[5] AMAC correctly determined that Appellant's corporation account (account 2502000700) is entitled to the standard maximum share insurance amount of $250,000. Despite the FCU's falsification of financial statements to mislead accountholders, Appellant has not demonstrated it is entitled to any funds beyond AMAC's share insurance determination. Accordingly, Appellant's claim for payment of $250,916.44 is denied. This decision does not affect Appellant's certificate of claim for $250,916.44 in uninsured shares.

Order

[3] Appellant does not assert a preference over similarly situated accountholders through a constructive trust as an equitable remedy to cure the fraud and does not claim to have had an agreement with the FCU to treat its deposited funds as trust property as opposed to regular share certificates.

[4] After the NCUA Board denied its insurance appeal (NCUA BD-06-05), the appellant sued the agency for its uninsured balance. The appellate court upheld the agency's decision to deny coverage and noted the doctrine of equitable estoppel is not available against the government. *Friends of Hebrew Inst. for the Deaf and Exceptional Children v. NCUA,* No. 06-0424-ag, 2007 U.S. App. LEXIS 6275 (2nd Cir. March 16, 2007).

[5] We note section 343(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act providing for unlimited share insurance for "noninterest-bearing transaction accounts," which took effect July 22, 2010, is inapplicable here.

For the reasons set forth above, it is ORDERED as follows:

The Board upholds the agent for the liquidating agent's decision and denies the appeal of Cascade Federal Credit Union.

The Board's decision constitutes a final agency determination. Pursuant to 12 CFR §745.203(c), this final determination is reviewable in accordance with the provisions of Chapter 7, Title 5, United States Code, by the United States district court for the federal judicial district where the credit union's principal place of business was located. Such action must be filed not later than 60 days after the date of this final determination.

So **ORDERED** this 17th day of February 2011 by the National Credit Union Administration Board.

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Mary Rupp
Secretary of the Board