Study B-400 May 23, 2003

First Supplement to Memorandum 2003-19

Financial Privacy (Discussion of Issues)

This memorandum updates information in Memorandum 2003-19.

CURRENT DEVELOPMENTS

California Legislature

The hearing of SB 1 (Speier) in the Assembly Banking and Finance Committee has been postponed.

Local Public Entities

The Alameda County privacy ordinance described in Memorandum 2003-19 is scheduled to take effect September 1, 2003. Bank of America and Wells Fargo Bank have sued Alameda County in federal district court for Northern California. *Bank of America v. Alameda County*, C03-02119 (May 5, 2003). Their argument is that the ordinance is preempted by federal banking regulations.

A comparable ordinance was adopted by the Marin County Board of Supervisors on May 13, 2003. It would apply to unincorporated areas of the county. It would become operative on January 1, 2004. Marin's County Counsel has indicated that the delay is intended to allow time for the state Legislature to take action on a statewide consumer privacy bill, and for the county legal staff to gauge the outcome of pending lawsuits against San Mateo and Contra Costa Counties' similar privacy ordinances.

EMPIRICAL DATA

We have so far been unable to obtain systematic data on the sale of customer personal information by financial institutions. It has been estimated that information sales is a $20 billion / year industry. However, financial institutions constitute but one segment of that industry. Some anecdotal information is set out below.

The best known case of a bank selling customer data surfaced in 1999, when the state of Minnesota sued U.S. Bancorp for selling its customer list to

MemberWorks, a Connecticut-based telemarketing company. U.S. Bancorp was estimated to have received $4 million up front, plus a 22 percent commission on all sales. MemberWorks sells everything from dental insurance to travel packages. The information sold by the bank included credit card account numbers, account balances, credit limits, checking account numbers, Social Security numbers, martial status, and bankruptcy scores. The case was settled for $3 million, and was the impetus for the privacy protections of the Gramm-Leach-Bliley Act.

Wells Fargo Bank has stated that in the past it sold customer data, but has not indicated its revenue from this practice. Wells Fargo discontinued the practice in 1999.

Great Western Bank has stated that it has never sold customer data. Great Western in 1999 estimated that 98% of banks do not engage in this practice.

Citibank was accused of selling its customer list to telemarketing firms for solicitations that violated state fraud statutes, receiving a percentage of the telemarketing sales. It is reported that in 2002 Citibank settled the case with 27 states for $1.6 million. The settlement did not disclose how much Citibank received from its list sales. Under the settlement, Citibank agreed to stop encouraging "deceptive solicitations," but not to stop selling its list altogether.

JURISDICTIONAL ISSUES

Memorandum 2003-19 raises jurisdictional issues in the application of the state privacy law. Should it apply to state residents, to financial institutions doing business in the state, to transactions entered into in the state?

In addition to jurisdictional complications mentioned in the memorandum relating to transients, financial institutions have noted complications relating to permanent residents as well. For example suppose one owner of a joint account is a California resident and another owner is not. Do California's privacy rules apply to all owners? What about the laws of other states where account owners may reside? What should be the applicable choice of law rules?

Again, the staff does not have any mature suggestions for dealing with the jurisdictional questions, at this point in the project. We raise issues now for the purpose of provoking discussion of the matter.

General Considerations

On May 21, 2003, the Senate Banking, Commerce and International Trade Committee and the Assembly Banking and Finance Committee held a joint informational hearing. The subject of the hearing was "Federal Preemption: The Impact on California Financial Institutions and Consumers".

The hearing was prompted by growing concern about federal preemption of state consumer protection laws. The concern is highlighted by three recent federal cases.

- *Bank of America v. City and County of San Francisco*, 309 F.3d 551 (9th Cir. 2002), holds that a municipal ordinance prohibiting a bank from charging an ATM fee to a nondepositor is preempted by the National Bank Act and the Home Owners' Loan Act, regardless of whether such an ordinance would be permissible under the Electronic Funds Transfer Act. (A petition for certiorari was filed in that case on March 20, 2003.)
- *American Bankers Association v. Lockyer*, 239 F. Supp. 2d 1000 (E.D. Cal. 2002), holds that a California statute requiring a credit card issuer to provide a "minimum payment" warning and disclosure in monthly bills is preempted by the National Bank Act, the Home Owners' Loan Act, the Federal Credit Union Act, and implementing regulations, regardless of whether such a statute would be permissible under the Truth in Lending Act.
- *Wells Fargo Bank v. Boutris*, 2003 WL 1220131 (E.D. Cal. 2003), enjoins the California Commissioner of Corporations from enforcing the California Residential Mortgage Lending Act against a national bank's wholly owned real estate lending subsidiary, on the basis that the Office of Comptroller of the Currency has exclusive visitorial powers over national banks and their operating subsidiaries.

The analogy is irresistible to possible federal preemption of state financial privacy law regardless of whether that law would be permissible under the Gramm-Leach-Bliley Act or the Fair Credit Reporting Act. However, each statute is unique and the preemption analysis must be individualized. We note in Memorandum 2003-19 that we are engaged in an independent analysis of the preemptive effect of the National Bank Act (assisted by the Hastings Public Law Research Institute) and of the other financial regulatory statutes on state privacy law.

Speakers at the joint informational hearing examined the far-reaching effect of the National Bank Act, the aggressive posture of the Office of the Comptroller of the Currency towards preemption of state consumer protection laws, and the compliant attitude of federal courts. A particular concern was the practical impact that preemption with respect to national banks would have on the ability of state banks, and other financial institutions, to compete.

The discussion at the hearing brought home to the staff a couple of key aspects of the Commission's study, as charged in the enabling resolution. The resolution specifies that the proposed legislation should accomplish a number of objectives, including:

(1) "Assure that regulated entities will be treated in a manner so that, regardless of size, an individual business, holding company, or affiliate will not enjoy any greater advantage or suffer any burden that is greater than any other regulated entity." If a provision of the financial privacy statute is determined to be federally preempted with respect to a particular class of financial institution, we may need to consider negating that provision for all financial institutions in order to achieve the goal of fostering competition.

(2) "Be compatible with, and withstand any preemption by, the Gramm-Leach-Bliley Act and the federal Fair Credit Reporting Act." But that is the least of our preemption concerns. We must also deal with the preemptive effect of the National Bank Act, the Home Owners Loan Act, the Federal Credit Union Act, and other federal financial regulatory regimes that also could have preemptive effect on state financial privacy laws. There may be ways the financial privacy statute can be structured so as to minimize the possibility of federal preemption under the various regulatory regimes.

We will have specific proposals to make on all of these matters in the future.

GLB Preemption

In Memorandum 2003-19 the staff suggests a provision that would direct the state regulatory authority to apply to the Federal Trade Commission for a preemption determination if the state authority believes there is a likelihood that a state privacy statute is inconsistent with federal law. That would have the effect of deferring the operative date of the statute until an FTC determination of nonpreemption is obtained.

Would such a provision run afoul of Article III, Section 3.5 of the California Constitution? That provision states:

> SEC. 3.5. An administrative agency, including an administrative agency created by the Constitution or an initiative statute, has no power:
>
> ...
>
> (c) To declare a statute unenforceable, or to refuse to enforce a statute on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulations.

The staff does not believe the constitutional provision would be an impediment. The California Supreme Court has considered the issue whether, consistent with the constitutional provision, the Legislature may direct an administrative agency, in effect, to implement a statute to the extent it does not conflict with federal law. "We conclude that such directions are permissible and do not frustrate the purpose of the constitutional provision, which is to limit the power of administrative agencies to refuse to carry out legislative mandates." *Reese v. Kizer*, 46 Cal. 3d 996, 998 (1988) (validating a statute directing Department of Health Services (1) to seek federal waivers necessary to implement provisions of the Medi-Cal Act and (2) not to implement provisions of that act for which appropriate federal waivers cannot be obtained).

CONTRACT CLAUSE ISSUES

The staff has made a preliminary investigation of the question whether the contract clause could impede California's ability to limit existing information sharing arrangements between financial institutions. (The staff is indebted to Jeff Vize, a UC Davis law student assisting the Commission, for his analysis.)

Interpretation and Application of Contract Clause

The United States Constitution precludes a state from enacting a law that impairs the obligation of contracts. U.S. Const. art. 1, § 10, cl. 1. Judicial interpretation has tempered the contract clause's force over time. The current standard for determining whether state legislation violates the contract clause is a three prong test, announced in *Energy Reserves v. Kansas Power & Light*, 459 U.S. 400 (1983):

> *Severity of Contractual Impairment and Past Regulation of the Industry*
>
> The threshold inquiry is 'whether the state law has, in fact, operated as a substantial impairment of a contractual relationship.' … Total destruction of contractual expectations is not necessary for

> a finding of substantial impairment. … On the other hand, state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a substantial impairment. … In determining the extent of the impairment, we are to consider whether the industry the complaining party has entered has been regulated in the past.

Id. at 411.

> *Significant and Legitimate Public Purpose*
>
> If the state regulation constitutes a substantial impairment, the State, in justification, must have a significant and legitimate public purpose behind the regulation … such as the remedying of a broad and general social or economic problem. … The requirement of a legitimate public purpose guarantees that the State is exercising its police power, rather than providing a benefit to special interests.

Id. at 411-12.

> *Reasonable Restrictions and Deference to Legislative Judgment*
>
> Once a legitimate public purpose has been identified, the next inquiry is whether the adjustment of the rights and responsibilities of contracting parties [is based] upon reasonable conditions and [is] of a character appropriate to the public purpose justifying [the legislation's] adoption. … "courts properly defer to legislative judgment as to the necessity and reasonableness of a particular measure."

Id. at 412-13.

Application of these standards to potential legislation governing financial privacy suggests that it is unlikely that retroactive application would raise a significant contract clause issue.

Severity of Contractual Impairment and Past Regulation of the Industry

A contract must be severely impaired or destroyed in order for the contract clause to apply. A financial privacy law that establishes an opt in regime could effectively destroy the value of a contract between financial institutions to share information. Under current doctrine the threshold for application of the contract clause would be met, and strict scrutiny would be applied to California's financial privacy law.

It is important to note that, "In determining the extent of the impairment, we are to consider whether the industry the complaining party has entered has been regulated in the past." *Energy Reserves,* 459 U.S. at 411. Financial institutions are heavily regulated, suggesting that regulation of their information exchange practices would be reasonably foreseeable.

GLB's encouragement of stricter state privacy laws buttresses the foreseeability of state regulation of the financial industry. With the relatively high level of publicity surrounding the privacy provisions of GLB and its state corollaries, financial institutions cannot claim ignorance. Information sharing contracts may even look like attempts to contract around an inevitable law, something the Supreme Court frowned upon in *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).

Significant and Legitimate Public Purpose

The party challenging a law under the contract clause "must demonstrate that legitimate governmental interests do not justify the impairment." *Northwestern Nat'l Life Ins. Co. v. Tahoe Regional Planning Agency*, 632 F.2d 104, 106 (9th Cir. 1980). The cases have adopted a broad view of what constitutes a significant and legitimate state purpose. A law imposing a generally applicable rule of conduct designed to advance "a broad societal interest" generally fares well under contract clause scrutiny.

When a court has not found a significant and legitimate purpose, there has generally been (1) a lack of a legislative findings on the matter (see, e.g., *Equipment Mfrs. Inst. v. Janklow*, 300 F.3d 842 (8th Cir. 2002)), or (2) a situation where benefits flow primarily to a narrow group (see, e.g., *In re Workers' Compensation Refund*, 46 F.3d 813 (8th Cir. 1995)).

Under this standard a strong case could be made for the constitutionality of financial privacy laws on the grounds of safety, economic well-being, and general welfare. Likewise, financial privacy legislation would satisfy the public purpose test, since it is intended to protect all individuals engaging in financial transactions in the state, not a limited group.

Reasonable Restrictions and Deference to Legislative Judgment

The Supreme Court has repeatedly held that state restrictions need only to be "reasonable" in light of the state's goals. There is no requirement that the least restrictive means be used to achieve those goals. On the whole, courts have given wide deference to legislative judgment. It is unlikely that any financial privacy legislation the Commission might recommend for enactment in California would be held to be unreasonable.

Staff Recommendation

In light of *Janklow*, it may be advisable to include in any California privacy legislation a statement of legislative intent and a showing of potential harm to California consumers. SB 1 (Speier), for example, includes detailed legislative findings and a statement of legislative intent. Similarly, the enabling resolution for this study includes legislative findings and directives that parallel those in SB 1 and could easily be converted into statutory language:

> **Legislative findings and intent**
>
> (a) The Legislature finds and declares all of the following:
>
> (1) The Financial Services Modernization Act, commonly known as the Gramm-Leach-Bliley Act, became law in 1999, and reformed the laws that define and regulate the structure of the financial services industry.
>
> (2) The Gramm-Leach-Bliley Act greatly liberalized the ways that financial institutions were permitted to share nonpublic personal information, and has, in turn, highlighted the extent to which various entities buy, sell, and use nonpublic personal information.
>
> (3) The Gramm-Leach-Bliley Act does not provide a comprehensive framework by which citizens may control access to their nonpublic personal information, but instead explicitly permits the states to enact laws that provide for greater protection of the privacy of nonpublic personal information.
>
> (4) The citizens of California have indicated their great concern with this issue, and have made clear their overwhelming desire to have control over the disclosure of their nonpublic personal information.
>
> (b) It is the intent of the Legislature in enacting this chapter to provide for the protection of personal information relating to, or arising out of, financial transactions, and to accomplish the following objectives:
>
> (1) Provide consumers with notice and the opportunity to protect and control the dissemination of their personal information by, and between, companies and their affiliates and non-affiliated third parties.
>
> (2) Authorize and direct affected regulators to prepare regulations that will recognize the inviolability and confidentiality of a consumer's personal information and the legitimate needs of entities that lawfully use the information to engage in commerce at the behest of consumers or for their benefit.
>
> (3) Assure that regulated entities will be treated in a manner so that, regardless of size, an individual business, holding company,

or affiliate will not enjoy any greater advantage or suffer any burden that is greater than any other regulated entity.

(4) Be compatible with, and withstand any preemption by, the Gramm-Leach-Bliley Act or the federal Fair Credit Reporting Act.

(5) Provide for civil remedies and administrative and civil penalties for a violation of the recommended legislation, including, but not limited to, attorney's fees, costs, actual and compensatory damages, and exemplary damages, including, but not limited to, relief as provided pursuant to Article 3 (commencing with Section 3294) of Chapter 1 of Title 2 of Part 1 of Division 4 of the Civil Code, and as provided in unfair business practices actions brought under Article 1 (commencing with Section 17000) of Chapter 4 of Part 2 of Division 7 of the Business and Professions Code.

The staff would adjust these findings and statements of legislative intent in accordance with the Commission's final recommendation on the matter.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary