NORTH DAKOTA BANKERS ASSOCIATION

LEGAL UPDATE

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GENERAL CREDITOR DEBTOR LAW

Under Texas Law, a Shareholder's Alter Ego Cannot Escape Liability to Uncle Sam [5TH CIR]

A debtor formed his own company, of which he was the sole director, officer, and shareholder, and exercised complete control over the company. The United States sued the debtor and his wife to collect federal taxes, and the government moved for summary judgment. The sole issue on appeal was whether the debtor's corporation existed as his alter ego, permitting the government to hold him personally liable for his corporation's failure to pay taxes.

In UNITED STATES v. LOTHRINGER, 2021 U.S. App. LEXIS 30283, 2021 WL 4714609 (5th Cir. Oct. 8, 2021), the Fifth Circuit Court of Appeals affirmed the district court's decision, holding the debtor was personally liable for his corporation's failure to pay taxes because it was the debtor's alter ego. First, the court evaluated the requirements under Texas law to establish that the corporation was the debtor's alter ego. The Fifth Circuit explained that under the law of Texas a company is an alter ego of an individual when there is unity between the corporation and an individual so that holding only the corporation liable would be unjust. Second, the district court had relied on several facts to establish that there was an alter ego relationship between the debtor and his company, including that the debtor was the sole shareholder, director and owner of his company, that he had complete dominion and control over his company, and he had failed to observe corporate formalities. The debtor challenged the district court's reliance on his failure to follow corporate formalities, because, he argued, a newly passed Texas statute superseded the case law relied upon by the district court. The Fifth Circuit rejected this argument, because the amendments only overruled the case law relating to contract claims. The debtor also contended that the district court improperly granted summary judgment after acknowledging some facts were disputed. The Fifth Circuit also rejected this argument, because the disputed facts were not material to the determination of the case. Accordingly, the Fifth Circuit Court of Appeals held the debtor was personally liable for his corporation's failure to pay taxes because the debtor's corporation operated as his alter ego under Texas law. By: Carlos Gracia carlos.gracia@ttu.edu.

FORECLOSURE

A Question to the Nevada Supreme Court Regarding Equitable Relief and Superpriority Liens at Foreclosure Sales [9TH CIR]

A homeowner executed a deed of trust on her property to secure a loan. After two reassignments, U.S. Bank became the beneficiary of the deed of trust. The property remained subject to covenants, conditions, and restrictions (CC&Rs) of a homeowner's association (HOA). The CC&Rs required "residents to pay annual assessments, and [gave the HOA] a right to impose a lien for unpaid assessments against the property." The CC&R also regulated the lien's priority and stated that the "lien of assessments, including interest and costs, shall be subordinate to the lien of any first Mortgages upon the unit." When the homeowner stopped making assessment payments and ignored the HOA agent's delinquency notices, the property went to a foreclosure sale where an investment company purchased it for approximately 3% of its fair market value. Accordingly, U.S. Bank filed a complaint against the HOA and the investment company, asserting "quiet title, wrongful foreclosure, and injunctive relief." Meanwhile, the HOA, its agent, and U.S. Bank were parties in another litigation in which the HOA agent made misrepresentations about when the HOA liens did and did not attach to a foreclosed property with a first deed of trust. The district court ruled for the HOA and investment company. It held that neither fraud, unfairness, nor oppression affected the property's sale in the case before the court. U.S. Bank appealed, and argued that the sales price, as a matter of law, was grossly inadequate at 3% of fair market value and that the CC&R mortgage protection clause and the HOA agent's previous misrepresentations in the other litigation qualify as evidence of fraud, unfairness, or oppression which affected the sale.

In U.S. BANK, N.A. v. S. HIGHLANDS CMTY. ASS'N, 999 F.3D 1185 (9th Cir. 2021), the United States Court of Appeals for the Ninth Circuit quickly decided that the sales price was grossly inadequate because anything less than 20% of fair market value allows a court to invalidate the sale. However, the court struggled to provide a direct answer to the second question posed in this case: "whether the misrepresentations made by the HOA and its agent in this case, specifically the mortgage protection clause in the CC&Rs and the [HOA agent's previous representation] that the superpriority lien would not extinguish the first deed of trust, constitute sufficient evidence of fraud, unfairness, or oppression affecting the sale to justify setting it aside." Traditionally, Nevada allows homeowner's associations to place liens on homeowner's residences for past-due assessments in their CC&Rs. The Nevada legislature gives a HOA lien priority over most other liens. Historically, homeowner's associations often place liens on property, but in order to persuade lenders to provide financing, they also add mortgage protection clauses in their CC&Rs that subordinate the HOA's superpriority lien to the bank's first deed of trust. According to case law, when an HOA forecloses on its lien, the first deed of trust is extinguished. Further case law provides that foreclosures sales can be set aside under equitable principles if there is "inadequacy of price" combined with "proof of some element of fraud, unfairness or oppression as accounts for and brings bout the inadequacy of price." Another case clarified that when the price inadequacy is "great," the court can grant relief based on only "slight evidence" of fraud, unfairness, or oppression. While that rule may sound straightforward, very little case law guidance exists to aid in the determination of when a misrepresentation constitutes unfairness. So, this court asked the Nevada Supreme Court to answer whether, "under Nevada law, an HOA's misrepresentation that its superpriority lien would not extinguish a first deed of trust, made both in the mortgage protection clause in its CC&Rs and in statements by its agent in contemporaneous arbitration proceedings, constitute slight evidence of fraud, unfairness, or oppression affecting the foreclosure sale that would justify setting it aside." As a result of the lack of a state answer to this question, the Ninth Circuit Court of Appeals certified this question to the Nevada court.

Editor's Note: In US. Bank, N.A. v. S. Highlands Cmty. Ass'n, 489 P.2d 514 (Nev. 2021), the Supreme Court of Nevada denied the Ninth Circuit Court of Appeals requests for certification. In its denial the Supreme Court of Nevada noted that two cases, Nationstar Mortgage, LLC v. Saticoy Bay LLC, Series 2227 Shadow Canyon, 133 Nev. 740 (Nev. 2017), and Shadow Wood Homeowner's Ass'n v. New York Community Bancorp Inc., 366 P.3d 1105 (Nev. 2016, both were mentioned in the Ninth Circuit Court's Order and constitute controlling precedent on the specific issues presented. The Supreme Court of Nevada stating it would apply already established law to the facts in the Ninth Circuit Court of Appeals' case. After this order, the Ninth Circuit Court of Appeals concluded that the U.S. Bank failed to raise a genuine issue of material fact that as to whether fraud, unfairness, or oppression marred the foreclosure sale so that it could be equitably set aside. See US. Bank, N.A. v. S. Highlands Cmty. Ass'n. 854 Fed. Appx. 823 (Mem.) (9th Cir. August 2, 2021). Accordingly, U.S. Bank's action was dismissed. The Ninth Circuit Court of Appeals stressed that the legal question presented to the Supreme Court of Nevada remains unanswered. By: Madison Pyle Madison.Pyle@ttu.edu.

FRAUDULENT TRANSFERS

Despite Several Badges of Fraud, Transfer was Not Fraudulent [BKR SD TX]

A man (debtor) and his wife used their home as collateral when borrowing money from a bank. Due to financial hardships, the debtor became unable to repay the loan, and the bank gave the debtor notice of acceleration and set a foreclosure date. The debtor got in touch with another hard money lender who stepped into the shoes of the original lender. The new lender and the debtor executed a forbearance agreement. Debtor attempted to sell the home during the period of forbearance but was unsuccessful and, rather than allow foreclosure, deeded the home to the lender in lieu of foreclosure. Shortly after this transfer of the deed, the debtor filed for bankruptcy. Another creditor sought to deny the debtor's discharge, arguing that the transfer of deed was fraudulent and, under 11 U.S.C. § 727(a)(2)(A), the debtor was not entitled to a discharge because he had engaged in a fraudulent transfer within one year before his bankruptcy. The badges of fraud included that the debtor had continued to live in the house after the deed had been transferred to the new lender.

In CANNELLA v. JACKSON (IN RE JACKSON), 625 B.R. 648 (Bankr. S.D. Tex. 2021), the court held that the transfer of the deed was not fraudulent and granted the debtor his discharge. The court first focused on the intent requirement of 11U.S.C. § 727(a)(2)(A). The court discussed next "badges of fraud," which have been considered by the Fifth Circuit and other courts to determining whether the debtor has the requisite fraudulent intent. Some of these "badges" were found by the court to be present in this case. Indeed, the debtor admitted that he was insolvent and had recently been sued by two other entities at the time he executed the deed in lieu of foreclosure. Despite this, the court determined that while the debtor had done things to affect his credibility, his actions did not indicate an attempt to defraud his creditor by deeding the home to the new lender. In fact, the transfer did not cause other creditors to recover less from the debtor. As a result, the court denied the creditor's request for relief and granted the debtor's discharge. By: Colton Sniegowski Colton.Sniegowski@ttu.edu.

BANKRUPTCY

Creditor Did Not Waive Right to Default Interest in Payoff Letter [BKR MD FL]

The debtor, a real-estate investor, owned two properties. The debtor filed for bankruptcy. A creditor's note was secured by a mortgage on the properties. The note provided for the automatic accrual of interest upon default at the highest rate permitted by state law. The debtor defaulted on the note before filing her Chapter 11 case. During the Chapter 11 case, the creditor timely filed its proof of claim, and sought interest at the default interest rate. The debtor did not object to either the proof or claim or the interest rate. Eventually, the creditor and debtor agreed upon an order that set the interest rate. When the debtor failed to make the payments as provided for in the agreed order, the debtor received a payoff letter from the creditor that calculated interest using the negotiated interest rate. The payoff letter stated: "figures are subject to change without notice." The creditor's vice president later testified that the creditor often offered borrowers discounted payoff opportunities conditioned upon payment before a specified date. The debtor filed an emergency motion to sell the properties, which the court granted on the condition that additional assets accompany the sales. Further, the court required the debtor to place the proceeds in escrow to fully satisfy the creditor's loan. Thereafter, another creditor obtained the original creditor's interest in the note, ignorant of the previous payoff letter. Later, the subsequent creditor filed an emergency motion for reconsideration of the sale order on the grounds that the amount owed should include significant additional default interest. Shortly after, the parties came to an agreement under which the sale proceeds would satisfy the existing outstanding loans and cover the disputed amount. However, the debtor argued that that the amount owed to the subsequent creditor should not include interest at the default rate. In response, the subsequent creditor argued that the debtor failed to demonstrate that she had relied on the payoff letter and that the original creditor never had permanently waived the right to collect default interest.

In IN RE FERRY, 631 B.R. 790 (Bankr. M.D. Fla. 2021), the court held that the debtor failed to show that she had relied on the payoff letter, and that neither creditor had waived the right to collect default interest. First, the court evaluated the presence or absence of a waiver. The court acknowledged that a waiver can be implied. An implied waiver may not be inferred, however, from "doubtful and ambiguous" circumstances. Here, the debtor failed to demonstrate unequivocal acts that demonstrated the creditor's intent to waive the right to collect default interest. Next, the court addressed the debtor's estoppel argument. Under state law the moving party must show the presence of three elements. Here, the debtor failed to meet the second element by failing to prove that she had relied on the payoff letter. Additionally, the payoff letter expressly stated that the payoff figure may be subject to change. Lastly, after it purchased the loan, the subsequent debtor had disavowed the payoff letter. As a result the bankruptcy court held that the debtor's lack of reliance on the payoff letter was determinative, and the debtor owed the default interest.By: Grant Coffey grant.coffey@ttu.edu.

Debt Was Dischargeable Because Debtor Had No Fraudulent Intent [BKR ND FL]

The debtor regularly obtained products from the creditor and repaid the creditor at the end of each crop year from the proceeds of his sales. After his crop failed, the debtor could not repay the creditor. In 2017, the debtor applied for assistance from the USDA under the "Non-Insured Crop Disaster Assistance Program" (NAP), naming each tract of land as a "farm" with numerous family members and friends listed as "producers." The debtor pledged to the creditor some of the NAP proceeds from a tract under the debtor's nephew's name. He signed the documentations claiming a power of attorney for his nephew, who was incarcerated at the time. However, the USDA denied the debtor's application for the tract under the nephew's name, explaining that applying for NAP proceeds under another person's name as "producer" was not allowed. Debtor, unaware of this rule for filing applications, did not apply under others' names after learning of this prohibition. Once the USDA denied the debtor's application for NAP proceeds, the debtor could not repay the creditor. In July, 2018, the debtor filed a Chapter 7 bankruptcy petition. The creditor sought to except the debt from discharge under 11 U.S.C § 523(a)(2)(A), among other Bankruptcy Code provisions. The creditor argued that the debtor obtained the forbearance through misrepresentation, false pretenses, fraud, and materially false statements and had a willful and malicious intent to injure the creditor.

In NUTRIEN AG SOLS, INC. v. GILBERT (IN RE GILBERD, 631 B.R. 921 (Bankr. N.D. Fla. 2021), the court noted that a debt is nondischargeable under § 523(a)(2)(A) if the debtor made a false representation with the intent to deceive creditor, and the misrepresentation caused the creditor's loss due to justifiable reliance on the false representation. First, the court explained that here the creditor failed to meet the burden of persuasion because a false representation must be made knowingly and fraudulently. Evaluating the facts of record, the court stated that the debtor genuinely believed he rightfully listed his nephew as the "producer" on the application and applied for the funds using the nephew's name. Once the debtor learned the error of this actions, he ceased applying for proceeds under others' names. Because the debtor had discovered this error months after he signed the assignment in the creditor's favor, his action lacked the necessary element of a false representation at the time the debtor executed the assignment. Second, the court explained that the creditor never questioned the conduct of the debtor when the debtor signed the assignment document as power of attorney for his nephew, who was not the creditor's customer. This unusual signature provided enough notice for creditor to inquire about the situation. For that reason, the court concluded that the creditor had not reasonably relied on the debtor's actions. Moreover, the creditor had not proven it was injured as a result of the assignment because the debtor was already indebted to the creditor at the time of the assignment. Therefore, the court entered judgment in favor of the debtor. By: Lauren Ottmers lauren.ottmers@ttu.edu.

SECURITY INTERESTS

Debtor Had Sufficient Rights in the Collateral to Grant Security Interest [BKR DE]

A bank asserted a security interest in a deposit account owned by a subsidiary of the debtor. The bankruptcy trustee maintained that the bank held no rights in the account because the subsidiary had not granted the security interest. The bank asserted that the debtor granted the security interest in the deposit account. The bank sought a declaration that it had a perfected security interest in the deposit account.

In WACHOVIA BANK, NAT'L ASSOC. v. WL HOLMES, LLC (IN RE WL HOLMES, LLC), 452 B.R. 138 (Bankr. D. Del. 2011), the court held that the bank maintained a perfected security interest in the deposit account owned by the subsidiary. Ultimately, the bank performed the actions necessary to fulfill the requirements in establishing the existence of an enforceable security interest in the deposit account as set forth in § 9-203 of the U.C.C. The trustee challenged one prong of these elements, which requires that the debtor have "rights in the collateral." To address whether a debtor holds sufficient rights in the collateral, the court looked to the debtor's control over the account. Here, all individuals authorized to manage the subsidiary's deposit account worked as officers of the debtor. Additionally, the subsidiary only held the power to transfer funds with the express consent of the debtor. The court found that the debtor demonstrated use and control over the account. Next, the court looked to whether the subsidiary consented to the debtor's collateralization of the deposit account. Evidence presented indicated that the subsidiary tacitly endorsed and consented to the grant of the security interest. The signature of the president of the subsidiary on the loan agreement signaled this endorsement. Thus, the court held that the bank established that the debtor possessed the requisite rights in the deposit account. As a result, the bank held a properly perfected security interest. By Marilyn Lorraine Haithcock Marilyn.haithcock@ttu.edu.

REAL ESTATE

Failure to Comply with Claim Filing Requirements of Bankruptcy Rules Limits Creditor's Reverse Mortgage Claim [BKR DSC]

A debtor secured a reverse mortgage loan on his primary dwelling. Debtor failed to pay property taxes in a timely manner, leading to the creditor's initiation of foreclosure proceedings. In response, the debtor filed a Chapter 13 bankruptcy petition before the foreclosure sale. The debtor's confirmed Chapter 13 plan provided for the debtor to cure the mortgage default and retain the property. Because it did not object to confirmation of the debtor's reorganization plan, the creditor found itself bound by the plan. Later, the creditor filed a motion to recover advances made for hazard insurance premiums after the confirmation of the Chapter 13 plan. The debtor objected, arguing that it did not have to pay the amount because the creditor had not filed a claim for this amount as required by Federal Rule of Bankruptcy Procedure 3002.1(c).

In IN RE LEGARE-DOCTOR, 634 B.R. 453 (Bankr. D.S.C. 2021), the court held that the creditor's failure to assert a claim for recovery in a timely manner, as required by Fed. R. Bankr. P. 3002.l(c), precluded any attempt to cure under debtor's Chapter 13 plan. The court rejected the creditor's argument that the rule did not apply in this circumstance, relying on the plan meaning of the rule, which requires that a creditor must disclose post-petition advances and expenses within 180 days of incurring them any such expenses using Official Form 410S2. Thus, the creditor could not recover from the debtor. By: Marilyn Lorraine Haithcock Marilyn.haithcock@ttu.edu.

EXEMPT PROPERTY

Wisconsin Does Not Explicitly Prohibit Avoiding Liens on Exempt Property [BKR WI]

A married couple filed for Chapter 12 bankruptcy. A few months later, they amended their papers to claim a state exemption in their tools of the trade and moved to avoid their bank's lien on those tools. Their creditor, a bank, held a secured claim of nearly $340,000 secured by the couple's real estate and personal property. Specifically at issue here was the bank's nonpossessory, nonpurchase-money security interest in the couple's tools of the trade that was valued at $27,500. No party disputed that the couple had not used loan proceeds to purchase the property at issue. It was also undisputed that the bank was a vastly oversecured creditor. The bank claimed that under, 11 U.S.C. § 522(f) the debtor could not exempt the tools because the applicable state late-that of Wisconsin--does not allow debtors to avoid liens on exempt property.

In IN RE KLUG, 633 B.R. 883 (Bankr. W.D. Wis. 2021), the court noted that Wisconsin allows its debtors to claim either state or federal exemptions and further noted that 11 U.S.C. § 522(f)(3) provides a two-part test that determines the amount a debtor can avoid on its creditor's non purchase money, non-possessory lien on its tools of the trade. The court reasoned that, if the couple met only one of both tests, they can avoid the entire $27,500 asserted by the bank on their tools of the trade. However, if the couple met both parts, they can only avoid half of that amount. The first part of the test (11 U.S.C § 522(f)(3)(A)) "is satisfied if either (i) applicable state law 'permits a person to voluntarily waive a right to claim exemptions...' or (ii) the state has opted out of using federal exceptions." Here, the couple used a state exemption that satisfied the first part of the test. Part two of the test (11 U.S.C. § 522(f)(3)(B)) is met when "the applicable state law-prohibits avoidance of a consensual lien on property otherwise eligible to be claimed as exempt property." The couple took a plain-meaning approach to interpret this portion of the Bankruptcy Code and argued that they did not meet part two of the test because Wisconsin does not explicitly prohibit avoidance of consensual liens. The court agreed, explaining that "[t]he Wisconsin exemption statute does not explicitly prohibit the avoidance of a consensual lien." For that reason, the court concluded that the couple was entitled to the full exemption of $27,500. By: Madison Pyle Madison.Pyle@ttu.edu.

Tracy Kennedy
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Role of NDBA General Counsel

NDBA's general counsel serves as the attorney for the association. Although Tracy is pleased to be able to serve as a resource for NDBA members in responding to their questions, she is providing general information, not legal advice. Banks must obtain legal advice from counsel who has been retained by the bank to represent the bank's interests in a specific matter.

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