NORTH DAKOTA BANKERS ASSOCIATION

LEGAL UPDATE

A newsletter covering bank legal and compliance information.

Volume 23 • Issue 2

February 23, 2023

BANKRUPTCY

A Debt to Bank was Nondischargeable in Chapter 7 Bankruptcy Because it was Obtained through Falsehoods [BKR WD TX]

A family-owned business refinanced its debts by borrowing money from a bank. The debtors personally guaranteed the note, agreed to refrain from selling their interest in the business, and pledged to be involved in the "day-to-day executive management" of the business. Throughout the entire negotiation process, the debtors made numerous false statements to the bank, such as that the business was a woman-owned business and that the debtors had no plans to sell the business. A year after executing the note, the debtors sold their interest in the business to a separate entity (the third party). As part of the buyout agreement, the third party assumed responsibility for paying off the business loan. At no time during the buyout did any party inform the bank of the sale. Shortly after selling the business, relations between the debtors and the third party soured. The third party refused to uphold its end of the contract and purposefully defaulted on the monthly note payments. Upon default, the bank contacted the debtors and discovered that the debtors had sold the business. Although the bank attempted to work with the debtors, who had personally guaranteed the loan, the debtors defaulted on their obligation to pay the bank and then filed for bankruptcy. The bank then sued the debtors claiming they had obtained the loan from the bank by false pretenses and actual fraud. The bank sought a ruling that the debt was nondischargeable.

In Tex. Capital Bank, N.A. v. Womack., 2022 WL 2659412, 2022 Bankr. LEXIS 1898 (Bankr. W.D. Tex. July 8, 2022) (opinion not yet released for publication), the court explained that under section 523(a)(2)(A) of the Bankruptcy Code, a debt is nondischargeable if it was "obtained by false pretenses, a false representation, or actual fraud." To succeed in proving a nondischargeable claim, the creditor must show by a preponderance of the evidence:

> (l) that the debtor made a representation; (2) that the debtor knew was false; (3) that the debtor made with intent to deceive the creditor; (4) that the creditor actually and justifiably relied upon; and (5) that the creditor sustained a loss as a proximate result of its reliance.

In its analysis, the court distinguished false pretenses and false representation from actual fraud. While false representation and false pretenses deal with deception regarding previous or current facts, actual fraud encompasses lies regarding future facts. In this case, the debtors had made false representations to the bank during the loan approval process by claiming the business was "woman owned." Additionally, the debtors had committed actual fraud by deceiving the bank when they said they had no plans to sell the business in the future. In conclusion, the court found that the bank proved all five requisite elements and thus, the debt was nondischargeable. However, the court had also found that the debtors had not committed a "willful and malicious injury" under 11 U.S.C. § 523(a)(6) that would prevent the debt form having been discharged. By Joshua Shetler joshua.shetler@ttu.edu.

FDCPA

Debt Collection Letter Did Not Violate the FDCPA [D KS]

A debt collector attempted to collect a student loan debt owed by the debtor through a letter that the debtor claimed violated the Fair Debt Collections Practices Act (FDCPA). The debtor had borrowed money to pay for schooling and defaulted on that debt, and that debt was sold to a creditor who contracted with the debt collector to assist in collecting the debt. From there, the debt collector sent the debtor's employer a packet with an order to withhold a portion of the debtor's earnings and to transfer those withheld earnings to the debt collector. The first two pages of the letter were addressed to the debtor's employer. The first page contained the creditor's logo, the title "Order of Withholding from Earnings," and some text

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that clarified that the letter was an attempt of the creditor to collect on a debt owed to the debt collector. The second page of the packet included details of who the debtor was, his debt owed, and the payments to be withheld. This page also included the name of the debt collector, its address, phone number, and instructions to send the withheld earnings to the debt collector, and to contact the debt collector if any further information was needed. The employer of the debtor withheld a portion of the wages and remitted the wages to the debt collector based on the letter's instructions. The debtor then sued the debt collector alleging that it had violated the Fair Debt Collections Practices Act (FDCPA). He specifically claimed that the debt collector violated the act using "false, deceptive, or misleading representation[s], or unfair or unconscionable means" in the letter by trying to make it seem as though the letter had been sent by the creditor, and not by the debt collector.

In Tavernaro v. Pioneer Credit Recovery, Inc., 43 F.4th 1062 (10th Cir. 2022), the court concluded that the debtor had failed to allege facts sufficient to establish that the collection agency violated the FDCPA, and the letter sent by the debt collector attempting to collect the debt owed by the debtor did not violate the FDCPA. Here, the debtor's claims were all centered on the same issue: whether the letter was materially misleading. The court considered the various tests the courts have used to determine whether a communication is materially misleading under the FDCPA, and after considering the tests, required that the debtor provide sufficient facts to show that the debt collector's letter was false, deceptive, or misleading, and that the statements in it that were false, deceptive, or misleading had the ability to thwart the reasonable consumer's ability to respond. Under the FDCPA, creditors attempting to collect a debt cannot use false, deceptive, misleading representations, or unfair or unconscionable means to do so.15 U.S.C. §§ 1692e, 1692f Under these sections, a creditor violates the law if it has not used its "true name" and has made false representations to attempt to collect the debt. § 1692e(J4), (JO). To prevail on an FDCPA claim, the debtor must show materiality which, here, means that a reasonable consumer would be frustrated in his or her ability to respond to the letter. Here, the court determined that a reasonable consumer would read the letter in its entirety and try to understand its contents. If when reading the letter, the reasonable consumer would only find the letter to have one meaning, instead of multiple meanings, then the representation in the letter would not be misleading. On reviewing the letter, the court found that a reasonable consumer would not be misled by the letter because it identifies the creditor and states that the letter is an attempt by the debt collector to collect on a debt owed. Simply put, the letter clearly stated who the creditor was and who the debt collector was, and what their relationship was. Thus, the court concluded that the letter was not materially misleading and that a reasonable consumer could not misunderstand its contents or the identities of the creditor and debt collector. Therefore, the letter did not violate the FDCPA, and the case was dismissed for failure to state a claim. By Kyndsey Jones Kyndsey.jones@ttu.edu.

GENERAL BANKING

The Requisite Mental State Requirement for Bank Fraud [6TH CIR]

A lawyer represented a personal injury client and soon after hiring the lawyer the client was struggling to receive updates on the case. The client soon found out that the lawyer had settled the client's case without her knowledge and had then deposited the settlement checks into the lawyer's personal bank account. The client continued to press the lawyer for the money but was only given bits and pieces of the settlement. Ultimately, the client hired another attorney to recover the remaining settlement and soon learned that the lawyer had continued his practice of unauthorized settling and forging monies at the expense of other clients. Several of his clients filed actions with the Tennessee attorney disciplinary authorities and another contacted the District Attorney's office, after which the lawyer was disbarred and arrested on state stolen property charges. The central issue at the lawyer's federal trial was whether he had the requisite intent to commit bank fraud, because by depositing checks with forged signatures in a bank he allegedly had committed bank fraud. The court noted that a bank, by accepting a forged check, necessarily distributes those funds to an unauthorized party, which can prevent a bank from otherwise using the money without risking liability to itself. The defendant claimed that he lacked the intent required under the statute because he had suffered mental injury while paying college football.

In United States v. Skouteris, 51 F.4th 658 (6th Cir. 2022). The court ruled that the findings needed to prove an 18 U.S.C. §1344(1) violation required the individual to knowingly execute or attempt to execute a scheme to defraud a financial institution, to do so with the intent to defraud, and for the financial institution to be federally insured. The appeals court in this case specifically discussed the first two elements because the third element was not disputed by either party. As a result of the attorney's actions the bank was wrongfully deprived of its use of the funds, therefore fulfilling the "intent to defraud" requirement of the statute. Lastly, the court looked to the intent to defraud element to determine whether the traditional or modern approach should be applied in determining if the lawyer knowingly intended to defraud a bank. Here, the court determined that under the statute the requisite mental state requires the individual to know he or she is likely to deprive the bank of its property interests but does not require that

the defendant have the purpose to defraud and that had been established in this case. Accordingly, the court upheld the verdict below. By Khusbu Shah khusshah@ttu.edu.

LENDING

Business Challenges Caused by Covid-19 Did Not Establish a Valid Frustration of Purpose Defense [ND IL]

Debtors operated several franchised fitness center locations in the Chicago area. Debtors borrowed money from creditor, a financial services company, to finance gym equipment. The current dispute concerns two loans made by creditor to the debtors. Several provisions of the loan agreements are at issue in this case. As security for each loan, debtors gave creditor a security interest in debtors' gym equipment pursuant to two security agreements. The governor of the state in which the debtors' gyms were located ordered all fitness centers and gyms in the state to close to mitigate the spread of COVID-19. Shortly after, the creditor granted debtors 180-day deferrals of all payments due under the loan agreements. Even after debtors' gyms were permitted to reopen, their business continued to suffer greatly from the pandemic. When the deferral period for payments under the loan agreements expired, debtors failed to make further payments on the loans. Consequently, the creditor mailed written demands for the return of the gym equipment and payment of the amounts due under the loan agreements and guarantees from the debtors. When the debtors refused to comply, creditor filed this suit. Defendants claimed that the doctrine of frustration of purpose excused their nonperformance, and the nonoccurrence of government-regulated gym closures was a basic assumption underlying the loan agreements. Further, debtors argued that even though they were technically permitted to open their gyms after the first few months of the pandemic, the ongoing restrictions destroyed the economic viability of their business. In response, creditor asserted that the debtors' default under the loan agreement and guaranties entitled it to an order of replevin and detinue [a common law type of replevin] for repossession of the equipment.

In Firestone Fin., LLC v. WA Gym Naperville N., LLC., 21 C 1183, 2022 U.S. Dist. LEXIS 160754, 2022 WL 4094161 (N.D. Ill. Sept. 7, 2022), the court held that the economic impact on the debtors due to the pandemic, while unfortunate, did not amount to frustration of purpose. First, the loan agreements were not conditioned on the debtors' gyms being able to operate in a manner that the governor's order prohibited. Even if the debtors' contention that their continuing ability to provide low-cost gym access free from government interference was a basic assumption underlying the agreements, the debtors' frustration of purpose defense still failed because they did not show that the entire purpose of the contract was completely frustrated. Further, the fact that an event made a party's business unprofitable was not enough to show that it frustrated the purpose of the party's contract. Accordingly, the court concluded that the debtors' frustration of purpose defense failed as a matter of law. Second, the court affirmed the creditor's entitlement to replevin because the creditor had priority security interests authorizing creditors to repossess and sell the equipment upon debtors' default, the equipment had been wrongfully detained, and the equipment was not subject to any state tax, assessment, or fine. Lastly, the court concluded that detinue was proper because the creditor established, under the repossession provisions in the loan and security agreements, that its right to possession was superior to that of the debtors. Therefore, the court granted creditor's motion for summary judgment in its entirety and denied debtors' cross motion for summary judgment. By Elijah Benzvi elbenzvi@ttu.edu.

Lender Entitled to Receiver Based on Loan Provisions [NV]

Debtor owned multiple properties that needed significant repairs. Creditor demanded Debtor make deposits into repair and replacement escrow accounts for the properties. This demand was based on specific provisions in the loan agreement. The specific provisions also provided the Creditor could have a receiver appointed in cases of default. Debtor did not make the deposits, which the Creditor deemed a default under the loan agreements. Creditor sued and sought a receiver. The Debtor countersued, alleging breach of contract.

In Fannie Mae v. Westland Liberty Vill., 515 P.3d 329 (S. Ct. Nev. 2022), the circuit court held that the Debtor had a duty to make the deposits and that the failure to do so resulted in a default. Nev. Rev. Stat. § 32.260(2)(b) and Nev. Rev. Stat. § 107A.260(1)(a)(l), provide that a creditor is entitled to the appointment of a receiver when the debtor has agreed to the appointment of a receiver in the event of a default. Because the Debtor had agreed to the provisions in the loan documents, the Creditor was entitled to the appointment of a receiver based on the Debtor's default. By Brian Phan briphan@ttu.edu.

NEGOTIABLE INSTRUMENTS

Inclusion of Variable Interest Provision in Note Does Not Defeat Negotiability [D RI]

Plaintiffs defaulted on a mortgage obligation that was reflected in a note. One of the issues that the court had to decide was whether the note was a negotiable instrument. The borrowers claimed it was not negotiable because it provided for a variable

interest rate. For that reason, the plaintiffs contended, the amount due on the note could not be determined by reviewing it. The bank contended that the inclusion of a variable interest rate did not affect negotiability of the note. The parties also disagreed as to whether certain terms in the instrument that referred to other documents made it nonnegotiable. The bank moved to dismiss the complaint.

In Valdera v. PHH Mortgage Corp., C.A. No. 20-470-JJM-PAS, 2022 U. S. Dist. LEXIS 139869 (D. R.I. august 5, 2022), the court determined that the issue involved no factual disputes and thus could be decided on a motion for summary judgment. The court noted that Article 3 of the U.C.C. as adopted in Rhode Island provides that [i]f any instrument provides for interest, but the amount of interest payable cannot be ascertained from the description, interest is payable at the judgment rate in effect at the place of payment of the instrument and at the time interest first accrues." Accordingly, this provision did not defeat negotiability of the instrument, nor did the references to other documents to define terms in the note because those terms did not affect the amount that was due on the note. By the editors.

SECURITY INTERESTS

Secured Creditor That Fails to File an Allowable Proof of Claim in Subchapter V Chapter 11 Still Many Enforce its Security Interest [BKR MD FL]

The debtor had acquired almost all assets of a delivery service contractor. The debtor had obtained a loan from the creditor to enable it to purchase the assets. The parties agreed to a holdback of $150,000 to be held in escrow to protect the debtor. The debtor and the creditor signed a security agreement, and the collateral included 25 specific vehicles. The creditor perfected its security interest on all 25 vehicles through notations on the certificates of title, except for one vehicle that had been involved in a collision (the "Accident Truck"). Later, the debtor filed a voluntary petition for relief under Subchapter V of Chapter 11 of the Bankruptcy Code and listed the creditor as unsecured with no liquidated claim amount. The creditor then filed a late proof of claim in which it claimed it was owed $1,485,914.20, secured by the 24 vehicles, business equipment, commercial tort claims, the truck and trailer (that were not among the 24 vehicles previously mentioned), the Accident Truck, and the $150,000 in escrowed funds. The debtor objected to the creditor's claims and moved for summary judgment on the grounds that the claim should be disallowed because it was filed late, and that the creditor did not have a perfected security interest in the commercial tort claims, truck and trailer, Accident Truck, or the $150,000 holdback funds.

In In Re Bizgistics, Inc., No. 3:2 l-bk-02197-RCT, 2022 WL 2827551, 2022 Bankr. Lexis 2009 (Bankr. M.D. Fla. July 13, 2022) (opinion not yet released for publication), the court ruled that the creditor did not have an allowable proof of claim because it filed its claim after the deadline. Further, the court decided the creditor did not have a perfected security interest in the commercial tort claims, both trucks and trailer, and the holdback funds. The creditor should have perfected its security interests before the bankruptcy case was filed in order for the security interests to be enforceable in bankruptcy. The court also found that the creditor had not included commercial tort claims in any of its security agreements with the debtor and for that reason, did not have a perfected security interest in commercial tort claims. Additionally, the court noted that debtor had no current commercial tort claims so there would be nothing to recover from in any event. Next, the court held that because the creditor did not notate its security interest on the certificate of title for the Accident Truck and the truck and trailer, the creditor had no perfected security interest in that collateral. Finally, the court ruled that the creditor had no claim on the holdback funds because the debtor did not actually hold the $150,000 and the creditor did not have physical access to the holdback funds. Also, the creditor had failed to obtain a perfected security interest in the funds before the bankruptcy petition date, and for that reason also it did not have a perfected security interest. Nevertheless, the court rules that under 11 U.S.C. § 506(d)(2) and Bankruptcy Rule 3002(a) the lender's security interest in the collateral in which it had perfected a security interest before bankruptcy was preserved and enforceable. By Maycee Redfearn maredfea@ttu.edu.

Creditor Has Security Interest in Purchase Money Consumer Goods Despite Goods Becoming a Fixture [BAP DSC]

A debtor granted a bank a purchase money security interest in certain goods. The bank financed the debtor's purchase of siding for his primary residence. The debtor later filed for bankruptcy and the bank filed a proof of claim asserting a security interest in the siding. The debtor argued that the bank's interest was not secured and challenged the sufficiency of the agreement to create a valid security interest. The debtor also argued that the bank has not perfected its interest in the siding.

In In re Dabbs, 625 B.R. 15 (Bankr. D. SC. 2021), the court overruled the debtor's objection to the bank's claim. The court first considered whether the agreement was sufficient to create a security interest in the property acquired by the debtor. The court determined that the agreement contained clear language of intent to grant a security interest in the consumer goods purchased, and that an attached invoice adequately described

the goods subject to the security interest. The court also considered whether the security interest had been properly perfected. The court held that the bank's security interest was properly perfected because under S.C. Code Ann. § 36-9-309(l) because a purchase money security interest in consumer goods is automatically perfected. Finally, the court considered whether the security interest was severed when the collateral became a fixture on the debtor's real property. The court held that a properly perfected security interest is not lost when it subsequently becomes a fixture on real property and retains its priority status over subsequent interests that are not mortgages on the real property. By Levi J. Bowman levbowma@ttu.edu.

VALUATION

Comparable Sales Used to Value Home in Chapter 12 [BKR KS]

Debtors filed for Chapter 13 bankruptcy and Creditor had a claim secured by a manufactured home. Debtors claimed the manufactured home had a value of $41,000 after taking a $10,000 deduction for moving costs. Debtor used the comparable sales method of appraisal commonly adopted by real property appraisers to determine the home's value. Creditor objected to the Debtor's proposed Chapter 13 plan, claiming that the value of the home was $72,147.98. Creditor used the J.D. Power manufactured home depreciated cost valuation data, adjusted for condition, additional features, and estimated repair costs to determine the home's value.

In In re Lay, 645 B.R. 611 (Bankr. D. Kan. 2022), the court held that the comparable sale appraisal method used by the Debtor better estimates the retail value of the manufactured home because the location of the manufactured home was in a rural, sparsely populated region in the far southwest corner of the State of Kansas, and the appraiser had used comparable sales that were near the home, whereas the creditor's appraiser used data based upon a multistate region and then adjusted the value upward for the State of Kansas. The court also held that the value of a manufactured home should not be reduced by the cost to move it because the resulting appraised value would include a hypothetical event that may not occur. The court therefore concluded that the value of Debtors' manufactured home was $51,000 and not $41,000 for purposes of their Chapter 13 plan. By Brian Phan briphan@ttu.edu.

WIRE TRANSFER

Court Refuses to Dismiss Claim Against Bank for Sending Wire Transfer [ED NY]

A customer instructed a bank to send a wire transfer to enable the customer to purchase property. However, the instructions the customer gave the bank were flawed. After directing the bank to send the wire transfer, the customer contacted the bank and directed it not to send the wire transfer. Nevertheless, the wire transfer had been sent. The customer sued the bank, alleging breach of contract, conversion and bad faith. The bank moved to dismiss the complaint.

In Jakob v. JPMorgan Chase Bank, N.A., 22-CV-03921 (HG), 2022 U.S. Dist. LEXIS 203490 (E.D.N.Y. Sept. 8, 2022), the court did not dismiss the breach of contract cause of action against the bank. The plaintiff had alleged in his complaint that he "immediately" informed the bank that it should cancel the wire transfer. Because the wire transfer instructions had been received by the bank at 4:26 p.m., the court concluded that the bank may have been able to stop the wire transfer before the transfer was sent if it had been sent the next morning. If so, the bank's inaction would have violated the Wire Transfer Agreement it had entered into with the plaintiff. However, the court did dismiss the causes of action for conversion and bad faith because the plaintiff had not properly pied all the requisite elements of those causes of action under New York law. By the editors.

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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