NORTH DAKOTA BANKERS ASSOCIATION

LEGAL UPDATE

A newsletter covering bank legal and compliance information.

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WIRE TRANSFERS

Strict Five-Year Deadline to Make Chapter 13 Payments [10TH CIR]

This case arose between beneficiaries and a beneficiary's bank following a wire transfer scam. Before the distribution of the proceeds, an individual hacked the email of the beneficiary and sent the law firm representing the beneficiaries fraudulent wiring instructions. The law firm authorized the wiring of the funds as directed by the false instructions. Believing that a beneficiary owned the account, the beneficiary's bank accepted the wire transfer order at 12:01 PM. By 12:02 PM, the fraudulent account received the deposited funds. However, the account number provided by the scammer neither corresponded to the name nor address of the beneficiary. Fewer than three hours later, at 2:42 PM, the law firm notified the beneficiary's bank of suspected fraud as well as instructions to return the funds. Unbeknownst to the beneficiary's bank, the hacker shortly thereafter withdrew a portion of the settlement proceeds credited to the incorrect account. On the following day, the beneficiary's bank received an inquiry from the FBI into the suspected fraudulent activity. Following company protocol, the beneficiary's bank analyzed the records of customer accounts, which incorrectly indicated that no withdrawals had yet occurred. The law firm (which had settled with the beneficiary) later sued to hold the beneficiary's bank liable both for a misdescription of the account and for failure to immediately freeze or return the proceeds after the bank had received notice of suspected fraud.

In LANGSTON & LANGSTON, PLLC v. SUNTRUST BANK, 480 F. Supp. 3d 737 (S.D. Miss. 2020), the court held the beneficiary's bank neither liable for misdescription nor for failing to immediately freeze or return the funds after it received notice of suspected fraud. Misdescription occurs when a wire identifies a beneficiary by a number and name, but the account number and name provided belong to a different person. Under Article 4 of the UCC, which Mississippi has adopted, a beneficiary's bank has no duty to investigate a wire transfer if it lacks knowledge at the time of the transfer that the name and bank account number are wrong. Conversely, if the bank had actual knowledge of such conflict yet fulfilled the payment order nonetheless, it must suffer the loss. Thus, the analysis of the court turned to the question of the bank's actual knowledge. Because the beneficiary's bank first received notice of suspected fraud at 2:42 PM, the beneficiary's bank lacked actual knowledge of the misdescription until that time, which was nearly three hours after completion of the payment. Although data stored within the bank's computer system contained the proper identification, the UCC imposes no duty on the beneficiary's bank to verify the wire transfer information provided with that data. Therefore, because the beneficiary's bank lacked actual knowledge of misdescription at the time of payment, the court held the bank was not liable for misdescription. Turning to the failure of the beneficiary's bank to immediately freeze or return the funds after it received notice of the suspected fraud, the court considered attempted cancellations under Article 4A of the UCC. However, because acceptance of the payment order had occurred at 12:02 PM and the beneficiary's bank received notice well after fulfillment of the payment order, the court determined the request for cancellation was ineffective. Having previously accepted and fulfilled the wire transfer request, the court further held the beneficiary's bank not liable for failing to immediately return or freeze the funds after it had received notice of suspected fraud. By: Brooke Allen brooke.n.allen@ttu.edu.

BANKRUPTCY

Farming Debtors' Use of Cash Collateral Left Bank Adequately Protected [BKR D CO]

The debtors engaged in both farming and ranching. They filed for Chapter 12 bankruptcy after issues arose with the crops as a result of drought and cattle eating foliage poisoned with nitrate as a consequence of the drought. During the trial, the primary lender to the debtors, a bank, unsuccessfully argued that the cattle had not been poisoned, but instead sold, and, alternatively, the loses had resulted from poor husbandry. The court rejected the bank's argument, noting that the debtors had never been late on any loan before a drought, which started before the cattle poisoning. During the bankruptcy case, the debtors asked the court to authorize the use of cash collateral. In response, the bank objected to the use of cash collateral on the grounds that the debtors' use of such collateral threatened the bank's undersecured loan.

In IN RE GERKE, 634 B.R. 104 (Bankr. D. Colo. 2021), the court allowed the debtors to use cash collateral. The primary issue regarding the debtors' use of cash collateral came from whether the unsecured portion of the bank's loan would be "adequately protected." First, the court analyzed the history of adequate protection to describe how the concept allows courts to be flexible in protecting creditor and debtor interests. The court looked to Tenth Circuit precedent that held "a determination of the sufficiency of adequate protection is a factual finding, subject to the clearly erroneous standard on appeal." Next, the court evaluated whether the bank would be adequately protected if the bank received replacement liens in future cash, cattle, and crops. The debtors presented evidence that nothing had indicated that the livestock would decrease in value, relying on the anticipated mortality rate of the livestock. Rather, when the cattle put on weight, their value should increase. To counter, the bank used the death rate of the poisoning incident to show how the value of the livestock could greatly decease. Nevertheless, the court found the debtors' projections credible and reliable. Lastly, the court turned to an analysis of the crops and cash. The bank argued the debtors would have to use some crops and cash to keep the cattle during the winter months. However, the debtors provided sufficient evidence that they would not be placing the bank at greater risk. The bank objected, arguing that given the debtors alleged incompetence or dishonesty, they could not be relied upon to raise crops and cattle in the future. The court, however, was not convinced that the debtors had been dishonest, and believed that an allegedly misleading balance sheet had actually been prepared by the bank, not the debtors. The bank also objected to the use of cash collateral on the grounds that replacing the liens on crops and cattle on speculation amounted to "double dipping." The court also found this objection to be unpersuasive given the facts of this case. Ultimately, the court did impose a budget on the debtors, limiting the use of cash collateral to cases that would either maintain the status quo or improve the bank's position. By: Grant Coffey grant.coffey@ttu.edu.

NEGOTIABLE INSTRUMENTS

Holder of Note is an Assignee with Standing [3RD CIR]

A couple executed a promissory note in favor of a bank. In addition, they granted the bank a mortgage on two parcels of real estate as security for their loan. The note evidencing the loan provided that the bank could transfer the note, and that whoever became holder of the note would be entitled to receive payments. Years later, the couple defaulted on the loan. The bank assigned the mortgage to an assignee and transferred physical possession of the note to the assignee. The assignee gave the couple an opportunity to cure their default on the note, but they failed to do so. As a result, the assignee commenced a foreclosure action against the couple. The couple asserted ten boilerplate affirmative defenses and failed to comply with discovery. Days before the date the court set the trial to begin, when the time for discovery and amendments to the pleadings had passed, the couple attempted to introduce evidence and amend their answer to allege fraud and violations of the Truth in Lending Act. The magistrate judge excluded this new evidence and implicitly denied the couple's untimely motion to amend their answer. At the close of the assignee's case in chief, the court entered judgment on behalf of the assignee, holding that the assignee had standing and was entitled to recover on the note. The husband appealed the trial court's judgment on the grounds that his case had not been fully heard, and that the assignee did not have standing to foreclose on the mortgage.

In DLJ MORTGAGE CAPITAL, INC. v. SHERIDAN, 975 F.3d 358 (3rd Cir. 2020), the court held that the lower court had fully heard the husband's case as required by Federal Rule of Civil Procedure (FRCP) 52(c), and that the assignee did have standing. FRCP 52(c) is interpreted broadly to mean that being "fully heard" does not require that every shred of evidence be introduced. Rather, the court may consider the probative value of the evidence and use its discretion to determine the necessity of the introduction of additional evidence. Here, the court held that because of the couple's failure to comply with discovery, the only evidence the husband could put on was his own testimony. The husband had cross-examined the assignee's witness and the husband had testified, leaving no new evidence left to be heard. Additionally, the husband could not amend his answer and the trial court's denial of the motion to amend the answer was not an abuse of its discretion. Indeed, the court reasoned that allowing the amendment would have prejudiced the assignee and required additional discovery. Next, in analyzing the assignee's standing, the court applied a provision of Virgin Islands Law that mirrors the Uniform Commercial Code. The court explained that, under the law, holders of a negotiable instrument have a right to enforce that instrument. Following the law, the court defined "holder" as "the person in possession of a negotiable instrument that is payable either to bearer or an identified person that is the person in possession" of the negotiable instrument. Here, the assignee, the holder, as evidenced by a witness's testimony, had both physical possession of the note and possession of the allonge that held endorsements to the note. Furthermore, the debtors had presented no evidence that proved otherwise. Therefore, the assignee had standing to enforce the note, and, by extension, the right to recover on the note. The court therefore affirmed the trial court's judgment. By: Morgan Walton Morgan.R.Walton@ttu.edu.

PROCEDURE

Sorry Banks, but 16 Minutes is Still Too Late [D UT]

A debtor filed a Chapter 7 bankruptcy case. A bank sought to file a complaint objecting to the discharge of certain loans within the 60-day window given by the Federal Rules of Bankruptcy Procedure 4004(a) and 4007(c). The bank contended that its counsel had completed all necessary documents for the complaint just before the midnight deadline. However, upon attempting to file the complaint through the court's Electronic Case Filing System (ECFS), the bank's counsel encountered difficulties preventing him from properly filing the complaint. After all these setbacks, the bank's counsel eventually sent an email of the complaint to the debtor's counsel just after the deadline had passed. The bank's counsel subsequently succeeded in properly filing the complaint through the ECFS 16 minutes past the official deadline. As a result of falling outside the 60-days permitted, the bank filed a motion for an extension of time for filing the complaint. The debtor objected to the extension and moved to dismiss the complaint. The lower court held a two-day evidentiary hearing. It issued a decision denying the bank's motion for extension of time and granted the debtor's motion to dismiss given the user error by the bank's counsel which the bank appealed.

In STATE BANK OF S. UTAH v. BEAL, 633 B.R. 398 (D. Utah 2021), the district court affirmed the bankruptcy court's order denying the bank's motion to extend and dismissed its complaint. In making its decision, the court cited evidence of how the bank's counsel could properly use the ECFS up until the page with the demand field. The court next discussed how the bank's counsel successfully uploaded the complaint shortly after the deadline, which indicated the site's proper functioning prior to the deadline. Upon review of these facts, the court reasoned the most likely explanation for the supposed technical failures of ECFS came from user errors committed by the bank's counsel. This determination that user error caused the late filing prevented consideration of rule allowing for an extension that is necessary because of technical failures and confirmed for the district court that the lower court's denial of the bank's request for an extension had been proper. While the court noted that its decision to deny the extension with only a lateness of 16 minutes seems harsh, the ultimate determination stemmed from the last-minute user error. By: Riley Caraway rcaraway@ttu.edu.

LENDER LIABILITY CLAIMS

Bolstering Defenses to Lender Liability Claims: Circuit Court Rulings Reinforce the Utility of Workout Agreements

For lenders dealing with troubled loans, a loan workout agreement is often a great first step to address a tricky situation. A loan workout agreement may be a simple short-term standstill agreement, a mechanism to implement a long-term solution to the borrower's woes, or a path toward a palatable exit strategy to the relationship. Loan workout agreements, which often take the form of a loan modification agreement or forbearance agreement, may include, among other things, modifications to payment terms, forbearance from exercising certain rights and remedies, pledges of additional collateral, or an agreement to liquidate existing collateral

Obligors often welcome such an agreement, which can afford them breathing room to get back on the path to compliance. Nonetheless, defaults may nonetheless persist. Two recent decisions from the Tenth and Fifth Circuits illustrate that, even when a workout fails, a well-drafted workout agreement can provide lenders protection against lender liability claims once the relationship turns adversarial.

I. TWIFORD ENTERPRISES, INC. V. ROLLING HILLS BANK & TRUST, NO. 20-8048, 2021 WL 2879126 (10TH CIR. JULY 9, 2021)

In this case, the borrower operated a cattle ranching business in Wyoming. The borrower refinanced its cattle loans with a new lender, who later convinced the borrower to refinance its real estate loans with the lender the following year.

Thereafter, the lender stopped advancing funds to the borrower on the cattle loans, and those loans went into default. Over the next year, the lender and the borrower entered into several loan modification agreements and forbearance agreements to revise payment terms, extend maturity dates, and provide for additional credit advances. Crucially, all the modification and forbearance agreements contained releases or waiver provisions in which the borrower and the guarantors waived any claims or defenses relating to the loans.

The borrower later filed a Chapter 11 bankruptcy petition, and the guarantors filed an adversary complaint against the lender, alleging breach of contract, breach of the implied covenant of good faith and fair dealing, negligence, fraud, and negligent misrepresentation. The guarantors claimed that the lender misrepresented its confidence in the borrower's business to induce it to refinance its real estate loan and then the lender manufactured a default.

The trial court granted summary judgment in favor of the lender based primarily on the applicable statute of frauds, but it also held that regardless of the statute of frauds, the claims would be barred by the releases contained in the forbearance agreements.

On appeal, the guarantors did not argue that their claims fell outside of the releases' scope. Instead, the guarantors asserted that the releases were not enforceable because they were wrongfully obtained through economic duress.

The Tenth Circuit affirmed the trial court's ruling, noting that under applicable state law, an alleged victim of duress may not obtain part of the benefits of an agreement and disavow the rest. Since the guarantors obtained valuable concessions in connection with the forbearance agreements, such as credit advances, the Court held that they could not evade the releases under an economic duress theory.

II. LOCKWOOD INTERNATIONAL, INC. V. WELLS FARGO BANK, N.A., NO. 20-40324, 2021 WL 3624748 (5TH CIR. AUG. 16, 2021)

In this case, the borrower companies obtained two sizable lines of credit from their lenders. Within a year, the borrowers breached some of their obligations. Thereafter, the parties agreed to modify the lines of credit. In connection with the modification, the borrowers' sole owner executed a personal guaranty. Also, at the lenders' urging, the borrowers hired a chief restructuring officer (CRO).

Despite the loan modification and the appointment of a CRO, the borrowers' struggles persisted. The lenders grew frustrated, believing that the borrowers and the guarantor did not fully empower the CRO to address the borrowers' financial issues. The lenders gave the obligors an ultimatum: fully empower the CRO to operate or right-size the business within 48 hours or face an acceleration of the debt. The obligors agreed, but still defaulted on a sizable loan payment. To stave off acceleration, the obligors then executed a forbearance agreement in which they confirmed that the amended loan agreements were valid and enforceable, and waived and released the lenders from all claims. Before this forbearance period expired, the obligors executed a second forbearance agreement, which contained the same confirmation of the debt and releases in favor of the lender.

After the second forbearance agreement expired, the lenders accelerated the debt. This acceleration led to litigation among the parties that eventually was pared down to the lenders' breach of guaranty claim against the guarantor.

In his defense, the guarantor claimed the lenders engaged in a bait-and-switch scheme to obtain his guaranty and then install the CRO to control the business. Claiming that he only agreed to execute the guaranty and forbearance agreements under intense business pressure, the guarantor asserted affirmative defenses of fraudulent inducement and duress, both of which were rejected by the trial court on summary judgment.

On appeal, the Fifth Circuit noted that because the guarantor ratified his guaranty in connection with the forbearance agreements, the guarantor would need to invalidate the forbearance agreements before he could escape liability. The court found no basis to support a fraudulent inducement defense since the guarantor signed the first forbearance agreement after he already agreed to cede control over the companies to the CRO.

The Court also held that the guarantor's duress defense lacked merit. The guarantor argued that he only agreed to relinquish control to the CRO and execute the forbearance agreements because the lenders threatened to accelerate the loans. The court rejected this defense, noting that duress requires a threat of unauthorized action. The lenders were authorized to accelerate the loans and were simply using their leverage to extract a concession that they desired (i.e., installing the CRO). The court further noted that "difficult economic circumstances do not alone give rise to duress." Indeed, the Court opined that loan modifications would become rare if a borrower could later invalidate the agreement because of the economic pressure that precipitated the modification in the first place.

III. TAKEAWAYS

While the crush of loan delinquencies that we feared at the outset of the pandemic has not materialized, many observers believe that defaults and resulting workout volume will increase once government support and intervention wane. Lenders can expect that at least some of their borrowers will assert lender liability claims in the face of enforcement efforts.

To that end, these recent decisions offer a compelling reminder that a well-crafted workout agreement can serve multiple purposes. On the one hand, workout agreements are great opportunities for lenders to develop retention or non-retention strategies for troubled loans. On the other hand, even if the workout strategy fails, these agreements can help mitigate potential exposure to lender liability claims. Moreover, as the Lockwood case illustrates, so long as a lender is acting within the bounds of its loan agreement authority, it may elect to apply its leverage to obtain valuable concessions from a troubled borrower in a workout scenario. By: Bryan M. Mull Business Law Today.

Tracy Kennedy
NDBA General Counsel

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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