NORTH DAKOTA BANKERS ASSOCIATION

LEGAL UPDATE

A newsletter covering bank legal and compliance information.

Volume 23 • Issue 7

July 20, 2023

BANKING REGULATION

Do You Know How Your Partners Are Using Your Firms' Assets? [11TH CIR]

A bank and trust company (lender) made a personal loan to one of its customers (borrower), an individual who was a law firm manager. The borrower pledged his law firm's certificate of deposit (CD) as collateral for the loan. The borrower signed a security agreement securing the loan with the CD. The borrower maintained current payments to the lender for the loan. The lender began experiencing financial difficulties, and the Federal Deposit Insurance Corporation (FDIC) took over the lender's accounts and sold the borrower's loan to a different bank (bank). The borrower continued making payments to the new bank, which held the CD as collateral. The borrower eventually defaulted on the loan. According to the security agreement, this permitted the bank to liquidate the CD to pay the loan balance. The bank liquidated the CD and notified the borrower's law firm of the default and liquidation. The law firm did not respond. Instead, the law firm filed for bankruptcy, and a court convicted the individual who had borrowed the money of wire and financial fraud. The bankruptcy court approved the purchase of any claims the law firm had against others by an acquisition corporation (the corporation). The corporation sued the bank, claiming the bank was liable to it for the total amount of the CD because the borrower lacked the authority to pledge the law firm's CD as collateral to secure his personal loan. The corporation also argued that fraud occurred on the borrower's part and the borrower's lack of authority rendered the security agreement void. The corporation relied on law firm documents regarding the borrower's authority, documents that the lender did not possess at the time the security agreement had been entered into between the lender and the borrower.

In Landcastle Acquisition Corp. v. Renasant Bank, 57 F.4th 1203 (11th Cir. 2023), the court held that the D'Oench doctrine, 12 U.S.C. § 1823(e), and Langley case bars a lack-of-authority claim that relies on evidence outside an insolvent bank's records at the time the FDIC takes over the insolvent bank, citing to D'Oench, Duhme & Co. v. FDIC, 315 U.S. 447, 461 (1942), and Langley v. FDIC, 484 U.S.86, 92 (1987). The court emphasized that D'Oench does not bar lack-of-authority challenges; rather, it limits what evidence can be used to mount those challenges, functioning as an estoppel doctrine. The FDIC must be able to rely on an insolvent bank's official records to quickly sell and reassign the bank's assets, so the customers of the bank retain service without interruption. The evidence the corporation relied on included information outside the bank's records, information that neither the FDIC nor the original lender would have access to when the security agreement had been entered into. In addition, the court emphasized the Supreme Court's holding in Langley, reasoning that even if non-bank records supported the lack of authority, the security agreement would be voidable, not void. A failed bank can transfer to the FDIC voidable title of a note for the purposes of the D'Oench doctrine.

By Melissa Hightower mehighto@ttu.edu Edited By Riley Caraway

BANKRUPTCY

Loans Non-Dischargeable Due to Fraud [BKRSD TX]

The creditor loaned $50,000 to restaurant owners (the debtors) to improve and renovate their existing restaurant business and an additional $87,500 to help fund a second business's startup. Soon after, both businesses defaulted on their monthly payments, including rent and loan repayments to the creditor. The debtors then filed for Chapter 7 bankruptcy. The debtors sought to discharge the loans they had taken from the creditor, and the creditor sued to prevent this discharge. The creditor claimed that the debts should not be discharged due to fraud by the debtors obtaining those loans. The creditor alleged that the debtors were embezzling large portions of the loans and, in doing so, were willfully and maliciously injuring him. The debtors responded by arguing that the failure of their new restaurant was not because of any malicious actions on their part; instead, the failure was caused by the COVID-19 pandemic.

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In McClung v. Castaneda, 638 B.R. 737 (Bankr. S.D. Tex. 2022), the court separated the loans into two parts: first, the $50,000 loan for the primary business, and second, the $87,500 loan for the new restaurant. Starting with the primary business loan, the court examined the veracity of the creditor's claim under a preponderance of the evidence standard. It determined that the creditor did meet the standard when he provided evidence obtained through discovery that showed the debtors had transferred the creditor's loan to the primary business to their personal accounts. Once this information came to light, the court shifted the burden of proof to the debtors to rebuke the fraud allegation. The debtors failed to overcome the shifted burden because they could not account for any amount of the $50,000 loan being used in the primary business's operating expenses. The court found the intentional transferring of business funds to personal accounts to be a substantial action to cause injury to the creditor, thereby meeting elements for both an embezzlement charge and the willful and malicious standard to establish that a loan was non-dischargeable. This made the first loan debt non-dischargeable. Notably, the creditor did not have to show that the debtors intended to commit fraud if the creditor could show that the debtor's actions were substantially certain to cause the plaintiff's injury. In analyzing the second loan of $87,500, the court agreed that the creditor met the preponderance of the evidence standard for embezzlement by showing that his loans had been immediately transferred out of the restaurant's operating account by the debtors and comingled with the debtors' personal accounts. No funds were available for the operation of the new restaurant despite the creditor providing the $87,500 loan for that specific purpose. Just as in the case of the first loan, the debtors could not rebut the creditor's allegations when the burden of proof shifted to them. The court ultimately refused to allow a discharge of the $87,500 loan for the second restaurant, thereby denying the debtor's request for discharge on both of the creditor's loans. By Rafi Rahman rafrahma@ttu.edu Edited By Riley Caraway

Plan Confirmation Order Prevented Creditor from Seeking Indemnity from the Debtor's Successor [7th CIR]

A land developer ("debtor") entered into a contract with a financial services company ("creditor") and a deposit company ("deposit company") for bonds. These bonds secured performance for the debtor's land development agreements with municipalities. As a requirement of these bonds, the creditor included an indemnity clause that would require the debtor to repay the creditor in the event of a failure to develop the properties. Later, without satisfying its development obligations, the debtor filed for Chapter 11 bankruptcy. Both the municipalities and the creditor filed claims against the debtor. The bankruptcy court confirmed the debtor's plan to liquidate the estate. It later issued an injunction that prohibited the creditor from seeking payment and enforced the plan and confirmation order. Following the liquidation, all of the debtor's assets went into the trust, and a company bought it under the impression that all prior claims were extinguished. The municipalities wanted to draw on the debtor's bonds due to the failed development of the property but had to go through the bankruptcy court to establish liability. This left the municipalities suing the creditor for the bonds and the creditor attempting to bring the company into litigation as the debtor's successor. The company then turned to the bankruptcy court to assert that the creditor's actions were done in bad faith and, as a result, it should not be required to pay the indemnity owed to the creditor by the debtor. The bankruptcy court found the creditor in contempt of the plan confirmation order and found the debtor's responsibility to indemnify the creditor extinguished. The creditor appealed.

In Debtors. Fid. v. TRG Venture Two, LLC (In re Kimball Hill, Inc.), 61 F.4th 529 (Mar. 2023), the creditor asserted that the bankruptcy court lacked jurisdiction to enforce the debtor's confirmation order. The court did not find this argument compelling. Further, the creditor attempted to assert that the bankruptcy court imposed a burden of proof on it. The court determined that this did not occur, and that the bankruptcy court correctly applied the Taggart objective standard in reaching its conclusion. The court also evaluated the debtor's confirmation order and found that the creditor's claims were extinguished and did not return upon selling to the company. The court also noted that the creditor read and approved the confirmation plan that discussed this; therefore, it was aware of this fact. Despite the municipalities being able to seek relief against the creditor, this did not extend to the creditor being able to seek relief against the debtor or the company. The court discussed the differences between the property-based and entity-based claims. Ultimately, the court determined that the creditor lacked a reasonable basis to pursue claims against the company, and the trial court was proper in its rulings. By Avery Bertagna, abertagn@ttu.edu Edited By Riley Caraway

Court Refuses to Discharge Debt in Chapter 7 Bankruptcy Proceeding for Debtor Who Made False Representations to His Creditors [BKR DLA]

The debtor falsely represented to two creditors that he owned real property on which real estate development projects would be built. In exchange for the creditors' investment, the debtor promised to split the profit from the project with each creditor. The two creditors, without knowing each other,

signed contracts giving the funds to the debtor. In reality, the debtor neither owned the land nor had the rights to develop it. The debtor only ever owned one of the properties but sold it prior to contracting with one of the creditors. When the development plans eventually failed, the creditors wanted their money back and successfully sued. After the lawsuit, the debtor's wife purchased the property, which she and the debtor declared as her separate property under the cash deed. However, the debtor later indicated this property was, in fact, community property when he filed for Chapter 7 bankruptcy. The creditors again sued, seeking to deny the debtor's ability to discharge any debt owed to them mainly because of the debtor's misrepresentations regarding their investments. To that end, the creditors filed a motion for summary judgment.

In Playa Shirley, LLC v. Badeaux (In re Badeaux), 640 B.R. 665, (Bankr. E.D. La. 2022), the court granted the creditors' motion for summary judgment in part and denied it in part. Pursuant to 11 U.S.C. § 523, the creditors argued the debtor should not be allowed to discharge the debt owed to them under the judgments of the previous trial because the debtor obtained the creditors' money by false pretenses or false representations. The court held the record established that the debtor knew, or should have known, that he did not own the properties at the time he persuaded the creditors to invest under circumstances substantially certain to cause economic harm to the creditors. Thus, the court sustained the motion on this point. Second, the court rejected the creditor's argument that the debtor made materially false statements in the contracts he signed because those contracts did not include information that the debtor owned the properties, the amount the creditors would invest, or a specific return. Third, the court rejected the creditors 'claim that the debtor had embezzled their investments because the creditors had not shown what the debtor had done with the funds. Finally, the court found a genuine issue of material fact existed as to the debtor's intent when he misrepresented his wife's property as her separate property. It rejected the creditors' argument under 11 U.S.C. § 727(a)(2) because the debtor had explained that he and his wife mistakenly believed they had established the property as separate property under the purchase agreement. By Ty Koether tkoether@ttu.edu Edited By Peter Benson.

Debtor Enjoined from Filing Further Bankruptcy Cases After Filing Three Separate Cases to Frustrate Foreclosure [BKR MD FL]

To delay the creditor's foreclosure of the debtor's property, the debtor filed three separate Chapter 13 bankruptcy cases, each of which automatically stay the foreclosure. The debtor filed the first case on the day the creditor had scheduled the property to be sold. The debtor failed to make payments, so that case was dismissed. The debtor filed the second case three years later, once again, on the exact date the creditor had scheduled to sell the property. The debtor failed to file required documentation, so the second case was dismissed. After the second dismissal, the creditor once again scheduled a sale of the property, but the debtor filed the third case roughly one week before the third scheduled sale. The creditor filed a motion asking the court both to dismiss the case and to impose a two-year injunction prohibiting the debtor from filing additional bankruptcy cases.

In In re Quattry-Peacock, No. 6:22-bk-264-TPG, 2022 WL4076948, 2022 Bankr. LEXIS 2501 (Bankr. M.D. Fla. Sept. 1, 2022) (opinion not yet released for publication), the court granted the motion to dismiss and enjoined the debtor from bringing further bankruptcy cases for two years. In determining whether to grant the injunction, the court evaluated multiple factors including the debtor's litigation history, the debtor's motive in pursuing litigation, whether the debtor caused an unnecessary burden, and whether other sanctions would be appropriate. The court reasoned the only way to end the cyclical bankruptcy cases was to grant the injunction. The court found the debtor had been filing cases to keep the property while failing to make any progress on the payment plans. Further, the court discussed how the extensive litigation had burdened the court, its employees, and other parties to the litigation. The court reasoned a two-year injunction would be long enough to allow the creditor to foreclose on the property without any challenges in court, thus ending the burdensome cycle of litigation. By Maycee Redfearn maredfea@ttu.edu. Edited by Peter Benson.

CFBP

Middle-Course Application of Res Judicata to CFPB Settlement Agreement [11TH CIR]

The Consumer Finance Protection Bureau (CFPB) sued a company for violating several mortgaging-servicing practices in December of 2013. In February 20I4, the district court entered a consent judgment following a settlement agreement between the parties, and the settlement agreement established a requirement that the company would agree to a servicing-and-standards monitoring regime from 2014 until February 26, 2017. In turn, the CFPB agreed to release its claims against the company from prior to 2014 and to allow the company a chance to remedy any further violations that it might incur from 2014 to 2017. As soon as the consent judgment's term ended, the CFPB sued the company again, asserting that the company violated more federal consumer-protection laws

during the consent judgment term. The company challenged this suit, claiming that res judicata, or claim preclusion, barred the CFPB's suit against it on all claims relating to the company's conduct from 2014 until 2017, when the consent judgment ended.

In Consumer Fin. Prot. Bureau v. Ocwen Fin. Corp., 30 F.4th 1079 (11th Cir. 2022), the court applied a middle-of-the-road approach to res judicata application on the settlement agreement between the parties, remanding the case to the lower court to apply a middle ground approach to CFPB's claim against the company. The court first evaluated where it should look to apply res judicata. The court rested on established contract law precedent in looking at the settlement agreement itself rather than the allegations in the initial complaint. The court then evaluated the parties' intent in the settlement agreement: did the parties intend to preclude claims that may arise during the settlement judgment period, or not? Rejecting both the CFPB's and the company's arguments for how the court should apply res judicata in the matter at hand, the court instead took a middle-ground approach and determined that the effect of res judicata would rest on the consent judgment's servicing-standards-and-monitoring regime. Read carefully, the circuit court instructed the lower court to look back at the regime to determine whether the regime covered the legal violations that the company committed during the settlement judgment period of 2014-2017. In essence, the CFPB ended up not barred by res judicata if the settlement agreement had not covered the legal violations at issue. Res judicata, however, would bar any legal violations that occurred during that time and fell under the agreement. In doing this, the court achieved two important objectives that it argued served both parties: first, the settlement agreement would be meaningful by holding the parties to their compromise. On the other hand, the CFPB would still have the power to enforce the law with respect to issues the settlement agreement did not encompass. Therefore, the lower court would have to apply the court's middle-ground approach to claim preclusion, or res judicata, and look at the settlement agreement and determine if the CFPB's claims fell within the consent judgment and would be therefore barred, or if it fell outside of the consent judgment and could proceed. By Rafi Rahman rafrahma@ttu.edu Edited By Avery Bertagna,

FRAUDULENT TRANSFERS

Plain Language in Agreements Causes Banks' Claims to Be Fraudulent Transfers [BKR SD NY]

Several banks (the creditors) filed claims against the debtors: three U.S. corporations involved in the international jewelry business. The debtors had purchased diamonds from multiple affiliated jewelry businesses. The same principal owned both the debtors and affiliates. The creditors provided services to finance these transactions by extending credit to the affiliates. Under the arrangements, each affiliate could draw funds from its lines of credit with the creditors to facilitate transactions with the debtors. After completing the sales, the affiliates would issue invoices to the debtors instructing them to make payments to the creditors. The affiliates also pledged their invoices and accounts receivable as security to the creditors. The debtors filed for Chapter 11 bankruptcy, and the court appointed a liquidating trustee to administer the debtors' estates. The trustee commenced a case to avoid fraudulent transfers and moved for summary judgment, arguing the creditors' claims were not allowable under 11 U.S.C. § 502(d) because the creditors had been the recipient of a fraudulent transfer. The creditors cross-moved for summary judgment arguing their claims were obligations rather than transfers.

In In re Firestar Diamond, Inc., 643 B.R. 528 (Bankr. S.D.N.Y. 2022), the bankruptcy court granted the trustee's motion for summary judgment and denied the creditors' motion for summary judgment. In deciding whether the creditors' claims were transfers or obligations, the court turned to the plain language of the agreements. The court ruled the documents failed to establish obligations owed to the creditors by the debtors. Not only did the documents employ transfer-like language such as "rights of pledges" and "receivable agreements," but they also vested the ultimate responsibility for the repayment, of the creditors' loans to the affiliates-not the debtors. Thus, the court held the creditors' risk, with respect to the debtors, was derivative rather than contractual. The creditors advanced several counterarguments, all of which the court found unpersuasive. First, the creditors argued their claims were obligations because the creditors had acquired the claims pre petition. The court distinguished every case cited by the creditors to defeat this argument. Second, the creditors asserted the documents created a tripartite agreement between the creditors, debtors, and affiliates. Although the existence of a tripartite agreement would have created obligations directly between the creditors and debtors, the court refused to entertain the notion because the plain language of the agreements failed to establish such an arrangement. Third, the creditors insisted a tripartite agreement existed simply because the same principal owned the debtors and affiliates. The court disagreed and pointed out that the debtors, affiliates, and principal were all separate legal entities. Finally, the creditors begged the court to consider the parole evidence of the parties' past conduct and course of dealing to find a tripartite agreement. The court declined to apply the parole evidence rule because the agreements were unambiguous by their plain terms. Ultimately, the court held for the trustee by concluding the creditors' claims were disallowed because they had received fraudulent transfers and preferences within the meaning of Chapter 11 of the Bankruptcy Code. Accordingly, because the

previous payments to the creditors had been fraudulent transfers and/or preferential, therefore their remaining claims were disallowed. By Peter Benson pebenson@ttu.edu Edited By Riley Caraway.

HOMESTEAD

Nevada Honors Homestead Exemption Asserted by Incarcerated Criminal [NV]

The state charged a property owner with two counts of trafficking a controlled substance. The sheriffs office (sheriff) had searched the property and had found 80 grams of heroin. The sheriff filed a complaint for civil forfeiture on the property, the proceedings for which were stayed pending the property owner's criminal case. While in jail, the property owner recorded his initial declaration of homestead, which included his intent to claim and use the property as a homestead. The property owner plead guilty to one count of trafficking a controlled substance. The court sentenced the property owner to a term of incarceration. During the property owner's incarceration, a third party leased the property on a week-to-week basis. The agreement between the property owner and the third-party lessee acknowledged that the property owner intended the property to remain his homestead and planned to occupy the property after his release from prison. The sheriff argued the declaration of homestead was invalid because the property owner did not reside at the property when he recorded the declaration of homestead. Additionally, the sheriff argued the property vested in the sheriff before the property owner claimed the homestead exception. Even if the homestead declaration had been valid, the sheriff asserted the property would still be subject to forfeiture because the property owner had used it in trafficking drugs. The property owner argued his declaration had been recorded before a final process in the forfeiture action; therefore, his declaration preempted the forfeiture. The district court agreed with the sheriff and found against the property owner. The property owner appealed.

In Aguirre v. Elko Cnty. Sheriffs Off., 508 P.3d 886 (Nev. 2022), the appellate court held that a valid homestead is exempt from forfeiture and that a party can record a valid homestead up until the day of the forced sale. NRS 115.010(1) codifies the general rule exempting homesteads from any "forced sale on execution or any final process from any court." The Nevada Constitution creates only two specific exceptions to the homestead exemption, neither of which addresses civil forfeiture. The court explained creation of another exception to the exemption would conflict with the public policy purpose underlying the homestead exemption. That policy is to protect individuals from homelessness, and the court reasoned that creating a civil forfeiture exception to the exemption would render the property owner and his family homeless. To distinguish various precedents cited by the sheriff, the court found the property owner had recorded his declaration in good faith. In addition, the court determined the homestead declaration qualified the property owner as a bona fide resident despite both his temporary absence from the property due to incarceration and his use of the property for commercial purposes by leasing it to the third party. By Melissa Hightower mehighto@ttu.edu Edited By Peter Benson.

NEGOTIABLE INSTRUMENTS

Buyer's Meritorious Defense Fails Against Holder in Due Course of Notes Under the VCC [PA CIR]

A buyer purchased two entities that were owned and operated by the sellers. The buyer and sellers signed two purchase agreements and executed two installment notes (the notes) to make the purchase payments. The notes authorized by the buyer contained a confession of judgment for the unpaid balance plus interest, legal fees, and costs of suit in case of default. After that, the buyer learned a mechanic's lien had been filed against the sellers of the entities the buyer purchased from the seller. The buyer, learning of the mechanic's lien, started making all payments into escrow to offset the lien amount until it was satisfied by the sellers. Shortly thereafter, the buyer stopped making payments on the notes altogether. Meanwhile, the notes had been transferred in good faith for value to an entity with no involvement in the original transactions. In response to the buyer stopping making payments, the note holder entered a judgment by confession against the buyer on the notes. The buyer answered by filing a petition to open the judgment, arguing that the seller's non-disclosure of the mechanic's lien constituted a breach of the purchase agreements. Therefore, the buyers had a meritorious defense against the claims for payment under the notes. On the other hand, the note holder argued that the notes were enforceable because it was the holder in the due course of the notes, entitled to enforce the notes, and it had not participated in a breach of the purchase agreements. Therefore, the noteholders argued that the buyer lacked a meritorious defense against its claim for payment.

In Hellenic Capital, LLC v. Tran., 282 A.3d 804 (Pa. 2022), the court denied the buyer's petition to open the confessed judgment. The court held that although the buyer had a meritorious defense against the sellers, the noteholder was a holder in due course of the notes, both of which were negotiable instruments under the Uniform Commercial Code (UCC). The court relied on the UCC, which provides that a holder in due course, takes an instrument free from (virtually) all claims and defenses that could be asserted against the original payee (the sellers), including breach of contract. The court reasoned that

the noteholder was a holder in due course, entitled to enforce the notes because it received them in exchange for value and in good faith. Furthermore, the court noted that nothing in the record supported the idea that the holder had any knowledge of the mechanic's lien. Therefore, the buyer could not assert the seller's breach of contract as a defense against the claim for payment under the notes. By Trevor Shelton trevor.shelton@ttu.edu Edited By Avery Bertagna.

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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