

Financial Services Litigation

September 2010

NEWSWIRE

Lack of Due Diligence No Bar to Lenders' Reliance on Borrower's Financial Statements

By Robert A. Schwinger and Robert Kirby

The New York Court of Appeals recently ruled that fraud claims brought by four lenders who allegedly made loans in reliance on their borrower's false and misleading financial statements were adequate to survive a motion to dismiss. *DDJ Mgmt., LLC v. Rhone Group LLC*, 15 N.Y.3d 147 (2010). In reversing the decision of the Appellate Division, the Court found that the lenders' fraud claims could proceed where the lenders took action to protect themselves by obtaining specific written representations and warranties, regardless of the level of due diligence conducted.

Background

The lenders alleged that in March 2005, they loaned \$40 million to a remanufacturer of automobile parts, and that the borrower later defaulted on that loan. In addition to bringing suit against the borrower, the lenders brought claims, including a fraud claim, against various entities that owned or were otherwise affiliated with the borrower. The fraud claim alleged in part "that defendants presented [the lenders] with [borrower] financial statements that were false and misleading," and more specifically that those financial statements "inflate[d] the number with which [the lenders] were most concerned — [the borrower's] earnings before interest, taxes, depreciation and amorti-

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zation (EBITDA).”

Defendants filed a motion to dismiss the complaint for failure to state a claim, arguing in part that the lenders had “failed to make a reasonable inquiry into the truth of what defendants said [in the borrower’s financial statements]” and therefore could not adequately allege that they reasonably relied on the alleged misrepresentations in those financial statements. While dismissing other claims, the trial court refused to dismiss the lenders’ fraud claim. On appeal, however, the Appellate Division saw things differently, dismissing the fraud claim by concluding that the lenders could not “properly allege reasonable reliance on the purported misrepresentations [in the borrower’s financial statements]”

justifiable or reasonable is always difficult because it is “so fact-intensive” and “[n]o two cases are alike in all relevant ways.” Defendants argued that the Court should apply the long-standing rule that a plaintiff’s fraudulent misrepresentation claim should be dismissed where “the facts represented are not matters peculiarly within the [defendant’s] knowledge, and the [plaintiff] has the means available to him of knowing, by the exercise of ordinary intelligence, the truth.” *Schumaker v. Mather*, 133 N.Y. 590, 596, 30 N.E. 755, 757 (1892). The Court noted that “[t]his rule has been frequently applied in recent years where the plaintiff is a sophisticated business person or entity that claims to have been taken in [by unverified verbal assurances],” perhaps because in such circumstances the plaintiff “willingly assumed the business risk that the facts may not be as represented,” citing *Global*

The New York Court of Appeals’ decision in *DDJ Mgmt., LLC v. Rhone Group LLC* makes clear that independent due diligence is not an absolute prerequisite to a lender bringing a fraud claim based on false financial statements, at least where the borrower represented in writing the accuracy of its statements.

because they “never looked at [the borrower’s] books and records.” *DDJ Mgmt., LLC v. Rhone Group LLC*, 60 A.D.3d 421, 424, 875 N.Y.S.2d 17, 19 (1st Dep’t 2009). The lenders appealed to the New York Court of Appeals, the state’s highest court.

The Issue on Appeal

The Court of Appeals began its analysis by assuming without deciding “that the complaint adequately alleges that defendants made material misrepresentations,” noting that those allegations were “lengthy” and included “striking details,” including a series of alleged e-mails sent by the borrower that discussed the possible manipulation of financial statements. The Court proceeded to frame the issue on appeal as “whether, if the complaint’s allegations are true, a jury could find that [the lenders] justifiably relied on those misrepresentations.”

As the Court explained, the question of whether reliance is

Minerals & Metals Corp. v. Holme, 35 A.D.3d 93, 824 N.Y.S.2d 210 (1st Dep’t 2006), and *Lampert v. Mahoney, Cohen & Co.*, 218 A.D.2d 580, 630 N.Y.S.2d 733 (1st Dep’t 1995).

The Decision

The Court drew a line between cases like *Global Minerals* and *Lampert* and cases where the plaintiff alleged that it had obtained a written representation that certain facts were accurate:

Where, however, a plaintiff has taken reasonable steps to protect itself against deception, it should not be denied recovery merely because hindsight suggests that it might have been possible to detect the fraud when it occurred. In particular, where a plaintiff has gone to the trouble to insist on a written representation that certain facts are true, it will often be justified

in accepting that representation rather than making its own inquiry.

Here, as a condition of the loan, the lenders “insist[ed] that [the borrower] represent and warrant [in writing in the loan agreement] that the financial statements were accurate.” Among other things, the borrower represented in the loan agreement that the financial statements “were prepared in accordance with generally accepted accounting principles” and did not contain “any untrue statement of a material fact or omit[] to state a material fact necessary to make the statements contained therein not misleading.”

The Court concluded that, by insisting on these written representations and warranties, the lenders had “made a significant effort to protect themselves against the possibility of false financial statements.” The Court reached this conclusion despite acknowledging that “there were hints from which [the lenders] might have been put on their guard in this transaction,” including “the sudden improvement in profitability in the last month of the year [reflected in the financial statements]” and that “it took an auditor until March of 2005 to complete an examination of the 2003 financial statements.”

The Court “decline[d] to hold as a matter of law that [the lenders] were required to do more — either to conduct their own audit or to subject the preparers of the financial statements to detailed questioning.” The ultimate issue of whether the lenders “were justified in relying on the warranties they received is a question to be resolved by the trier of fact,” not by a court adjudicating a motion to dismiss. Accordingly, the Court reversed the dismissal of the lenders’ fraud claim and remanded for further proceedings.

Implications

The New York Court of Appeals’ decision in *DDJ Mgmt., LLC v. Rhone Group LLC* makes clear that independent due diligence is not an absolute prerequisite to a lender bringing a fraud claim based on false financial statements, at least where the borrower represented in writing the accuracy of its statements. That said, lenders would be prudent to exercise caution when relying on borrowers’ financial statements in the absence of due diligence. While the lenders here lived to fight another day, the Court of Appeals decision only concerned the sufficiency of the complaint and, thus, the ultimate reasonableness of the lenders’ reliance in the face of their failure to conduct due diligence will remain an issue of fact to be determined at trial. ☺

Court Affirms Regulator’s Jurisdiction Over Non-Resident Hedge Fund Based on E-Mail Offer

By Scott S. Balber and J. Carson Pulley

The Massachusetts Supreme Court recently affirmed a lower court ruling that the Massachusetts Secretary of the Commonwealth (“Secretary”) had jurisdiction to impose the state’s securities regulations on a non-resident hedge fund. In its unanimous decision in *Bulldog Investors General Partnership v. Secretary of the Commonwealth*, SJ-C-10589 (July 2, 2010), the Court upheld the determination that plaintiffs Bulldog Investors General Partnership (“Bulldog”), its principal Philip Goldstein, and affiliated hedge funds (collectively, “plaintiffs”) were subject to the Secretary’s regulatory jurisdiction because plaintiffs operated a website accessible in Massachusetts and had allegedly made, via e-mail, a prohibited offer to sell unregistered securities to a potential investor in Massachusetts.

Bulldog’s Solicitations and Massachusetts’ Regulatory Action

From June 2005 to January 2007, Bulldog maintained an interactive website that provided information about investment products it offered for sale. By registering with the site, users could obtain more specific information detailing Bulldog’s various hedge funds. In November 2006, a Massachusetts resident, Brendan Hickey, registered with the Bulldog site by providing the requested personal contact information. A Bulldog employee then contacted Hickey by e-mail and provided various documents regarding the performance of Bulldog’s hedge funds, among other information.

In January 2007, the Secretary filed an administrative complaint against Bulldog and Goldstein on the ground that the e-mail communication to Hickey was an illegal offer of unregistered securities in violation of Massachusetts law. In answering the administrative complaint, Bulldog and the other plaintiffs asserted several affirmative defenses, including that the Secretary lacked jurisdiction over Bulldog because it was not present in Massachusetts and that the complaint violated their right to free speech under then First Amendment to the U.S. Constitution. / continued page 4

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The hearing officer for the administrative proceeding concluded that plaintiffs had violated Massachusetts law. The officer ruled that the illegal offer constituted a sufficient nexus to afford the Secretary personal jurisdiction to regulate Bulldog. The hearing officer declined to rule on the First Amendment argument because Bulldog had by that time commenced an action in state Superior Court regarding its free speech claim and the hearing officer deferred to that court. A cease and desist order was issued and a \$25,000 fine imposed as a sanction for the violation.

Plaintiffs then brought an action in Superior Court for judicial review of the outcome of the administrative hearing. The Superior Court agreed with the hearing officer and concluded that personal jurisdiction over plaintiffs was statutorily authorized and satisfied due process. The appeal to the Massachusetts Supreme Court followed.

The Massachusetts Supreme Court Decision

In affirming the Superior Court's conclusion that the Secretary had personal jurisdiction over the non-resident plaintiffs, the Supreme Court held that the text and purpose of the Massachusetts Act establish that the Secretary is authorized to exercise personal jurisdiction over nonresidents in an administrative proceeding. This is because "the Secretary possesses the authority to conduct investigations inside or outside the Commonwealth to determine if a violation has occurred" because an "offer" [to sell unregistered securities] includes not only offers that originate within the Commonwealth but also ones directed into the Commonwealth and received [in the Commonwealth]."

Moreover, the Supreme Court held that because "any nonresident who has violated the act is deemed to have appointed the Secretary as his agent to receive process," the Secretary must also have the power to bring a respondent before a tribunal to adjudicate whether a violation had occurred.

The Supreme Court found that due process was satisfied because "[b]y contacting Hickey [via e-mail], the plaintiffs purposefully availed themselves of the privilege of conducting business activities in Massachusetts and invoked the protection of Massachusetts law." In short, the Court held that because plaintiffs had maintained a website accessible in Massachusetts and had sent a prohibited solicitation to a Massachusetts resident, it was reasonable for the plaintiffs to anticipate being subject to personal jurisdiction in Massachusetts.

Notably, the Court held that the presence of a disclaimer on the website asserting that the website was not an offer or solicitation, did not negate the conclusion that the e-mail communication to Hickey, which had no such disclaimer, was a prohibited offer or solicitation to sell unregistered securities. In addition, although additional steps would have been required before Hickey could actually purchase any securities from Bulldog, the Court held that the communication still constituted an offer because it was "designed to stimulate interest in purchasing Bulldog's securities." That was sufficient to constitute a violation.

Implications for Funds

The *Bulldog* decision cautions that, although a fund may not be a resident of a particular state in which it is remotely conducting business, it may still be subject to administrative enforcement proceedings in connection with its activities in that foreign state. To avoid inadvertent violations and enforcement proceedings in foreign states, funds must be familiar with the state's relevant securities laws and regulations before commencing any business in that state, even when such business is delivered remotely from outside the state through electronic means such as websites and e-mail. ☉

Fine Print Dooms Borrower's President to Personal Liability on Corporate Loan

By Thomas J. Hall and Caroline Pignatelli

A New York state court recently held that the president of Hooper Home Construction Corporation ("HHCC"), Dale R. Hooper ("Hooper"), was personally liable to plaintiff Wells Fargo Bank, N.A. ("Wells Fargo") for the default on the company's Business Line Credit Agreement ("BLCA"). In *Wells Fargo Bank NA v. Hooper Home Construction Corp.*, N.Y.L.J., July 1, 2010, at 26 (col. 3) (Sup. Ct. N.Y. Co. June 17, 2010), the court determined that, while Hooper had signed the loan agreement only as President of the borrower, the fine print terms of the agreement provided that he was personally liable.

The Guarantee

When HHCC applied for the loan, Hooper signed on behalf of

HHCC as its president, with the word “President” typed under his signature. The application did not contain a separate signature line for him to sign in his personal capacity as guarantor, and he did not sign a second time.

Immediately above the line on which he signed as President was the following language: “I certify that I have read and agree with the Terms and Conditions on the reverse side, including the personal guaranty.” The reverse side was two paragraphs long, and provided in relevant part:

By signing the front of this Quick App® application, I accept on behalf of the Business named on reverse (‘Applicant’) the terms and conditions of this offer, including the terms and conditions of the Customer Agreement that will be sent to the Applicant . . . I also accept in my *individual capacity* the terms of guaranty appearing below. I also, in my *individual capacity* (even though I may place a title or other designation next to my signature), jointly and severally unconditionally guarantee and promise to pay to Bank all indebtedness of the Applicant at any time arising under or relating to this application and/or the Customer Agreement.... (Emphasis added.)

The Lawsuit

Wells Fargo initiated suit against HHCC and Hooper premised upon HHCC’s alleged default of the BLCA agreement. Hooper moved for summary judgment dismissing the complaint, and Wells Fargo cross-moved for summary judgment against both HHCC and Hooper. After the court granted Wells Fargo’s motion for summary judgment with respect to HHCC, Wells Fargo renewed its motion as against Hooper and provided, at the court’s direction, a legible copy of the guarantee.

The court explained that “[o]n a motion for summary judgment to enforce written guaranties, the creditor is required to prove absolute and unconditional guaranties, the underlying debt and the guarantor’s failure to perform under the guaranties,” citing *City of New York v. Clarose Cinema Corp.*, 256 A.D.2d 69 (1st Dept. 1998). The court found that plaintiff had provided documentation of the underlying debt, and that it was undisputed that Hooper had not paid the debt. Therefore, the only issue was whether Hooper had personally guaranteed the loan.

In opposing personal liability, Hooper relied on the New York Court of Appeals decision of *Salzman Sign Co., Inc. v. Beck*, 10 N.Y.2d 63, 67 (1971). In that case, the Court of Appeals found

that, where the signing officer was also assuming personal liability, “the nearly universal practice is that the officer signs twice—once as an officer and again as an individual.” The *Salzman* court stated: “There is great danger in allowing a single sentence in a long contract to bind individually a person who signs only as a corporate officer.”

The court here, however, determined that *Salzman* was factually distinguishable. The court explained that, in contrast to *Salzman* where the personal guaranty was a single sentence buried in the body of the a long contract, the terms of the BLCA here were only two paragraphs long, the guaranty was “clearly and unequivocally worded,” and “the signature line alerts the signatory to the existence of the guaranty.”

Hooper additionally argued that he did not intend to be personally liable, he did not know or expect that Wells Fargo would hold him personally liable, and—for the first time in opposition to the renewed summary judgment motion—that he had oral confirmation from Wells Fargo that there would be no personal liability. The court rejected these arguments holding that Hooper was “obligated to exercise ordinary diligence to ascertain the terms of the document he signed” and therefore his allegations did not defeat Wells Fargo’s claims for summary judgment.

Finally, Hooper argued that he should be insulated from personal liability because he included his corporate title with his signature. The court flatly rejected this argument as contrary to the express words of the guaranty and relevant case law, citing *PNC Capital Recovery v. Mechanical Parking Systems, Inc.*, 283 A.D.2d 268, 271 (1st Dep’t 2001), for the proposition that a corporate title is “merely descriptive.”

Conclusion

Some New York precedent provides protection for corporate officers who make it clear that they are signing only in their corporate capacity and do not add a second signature. As this case demonstrates, however, such protections can be trumped by unequivocal provisions of the loan agreement that make it clear that the corporate officer who signs is assuming personal liability. This case demonstrates the need for corporate officers to read the fine print of loan documents—or, for that matter, any corporate contract. ☺

Court Invokes Prudent Man Standard to Uphold Collateral Trustee's Litigation Reserve Fund

By Thomas J. Hall and Laura Rowntree

After nearly fifteen years of unsuccessful attempts to recover \$71 million worth of securitized bonds after the 1990 bankruptcy of Continental Airlines, Inc., Bluebird Partners L.P. may have suffered its final defeat. In a recent decision by a New York trial court in *Bluebird Partners v. The Bank of New York, et al.*, No. 601016/1996 (New York Co. June 7, 2010), the court granted summary judgment to defendant Bank of New York (“BNY”), holding that the bank behaved prudently in establishing a litigation reserve fund as the collateral trustee in the airline’s bankruptcy.

A Contentious History

In 1987, Continental Airlines, Inc. (“Continental”) issued, in three series, \$350 million of bonds that were secured by over \$400 million in aircraft and airplane parts (the “Collateral”). Bluebird Partners L.P. (“Bluebird”) owned more than \$71 million of the first series of bonds issued by Continental. When Continental filed for bankruptcy and ceased making payments on the bonds in December 1990, approximately \$180 million of the bonds remained outstanding, secured by collateral then valued at roughly \$175 million. During the course of the bankruptcy proceeding, the value of the collateral decreased by about \$100 million. In February 1994, Bluebird commenced a federal action against several trustees of the bonds (“series trustees”), alleging various forms of breach related to their purported failure to protect the bondholders’ interest in the Collateral during the bankruptcy proceeding.

In December 1995, BNY replaced NationsBank of Tennessee, N.A. (“NationsBank”) as the Collateral Trustee under a Secured Equipment Indenture and Lease Agreement and several modifying agreements (collectively, the “Indenture”). By the time BNY succeeded it, NationsBank had established a litigation reserve fund in the trust, which held approximately \$34 million at the point of the succession. The reserved fund was established pursuant to the terms of the Indenture that provided for the indemnification of all expenses, including attor-

neys’ fees, incurred by the series trustees in the performance of their duties, and in the wake of the Bluebird litigation against the series trustees. The amount in the reserve fund, \$25.6 million, was based on NationsBank’s calculation of the amount of indemnification claims of the series trustees and several law firms it had incurred as of April 1995.

In February 1996, Bluebird brought a separate action in New York state court, which included BNY as a defendant. The suit alleged that the Collateral Trustee did not have the right to establish a litigation reserve in the trust, and that any funds contained therein were wrongfully withheld from the bondholders. BNY moved to dismiss all but two causes of action, which the court granted in part in December 1996, holding that “the Controlling Documents . . . require that the collateral trustee reserve adequate funds for the defendants’ expenses including litigation expenses, which the defendants are entitled to.” The Appellate Division later dismissed Bluebird’s breach of contract claim. Accordingly, when BNY filed for summary judgment in May 2010, only two causes of action remained.

Bluebird’s first remaining claim was that BNY breached its fiduciary duty to the bondholders “[b]y failing to release all of the remaining funds held in trust for the [bondholders], other than those funds reasonably necessary to satisfy the justifiable and necessary expenses of the Trust.” The second remaining claim was for a declaratory judgment “limiting defendants’ purported lien on the trust funds to an amount determined to be reasonably necessary to satisfy defendants’ indemnity rights, if any, (not in excess of \$5 million) and [ordering] BNY [to] make immediate distribution of all remaining funds and not unduly prolong the duration of the Trust.”

Applying the Prudent Man Standard

Addressing the merits of BNY’s motion for summary judgment, the court first acknowledged the obligation of BNY as Collateral Trustee to create and maintain a litigation reserve fund. The court further noted that the first priority payments under the Indenture were for the indemnification of the series trustees’ reasonable expenses, with the second priority payment including “the principal then due and payable, of premium (if any) and interest” on the outstanding bonds. Accordingly, the only issue left for the court to resolve was the question of whether that the amount of money BNY held in the litigation reserve fund was reasonable.

To analyze the reasonableness of the amount, the court invoked federal and New York State law, as well as the

Indenture's own terms, to apply the prudent man standard. The court cited the New York Appellate Division decision in *Beck v. Manufacturers Hanover Trust Co.*, 218 A.D.2d 1, 11-13 (1st Dep't 1995), for the established rule that a trustee, in the event of a default, "must act with undivided loyalty to the trust's beneficiaries and must exercise its rights and powers under the indenture using the same degree of care and skill as a prudent man would exercise under the circumstances in the conduct of his own affairs." Additionally, the court explained that a trustee must act not only prudently, but also in accordance with the rights and powers conferred on it by the indenture, as articulated by the Trust Indenture Act's provision on "Duties and responsibilities of the trustee," 15 U.S.C. § 77(c), which requires a similar degree of prudence as that demanded by New York law. Under the federal statute, upon

The Undisputed Facts

Rejecting Bluebird's procedural argument that "questions of reasonableness and prudence are fact intensive and cannot be decided on summary judgment," the court relied on the Court of Appeals decision in *Matter of Bank of New York*, 35 N.Y.2d 512, 519 (1974), which held that evidence of prudence and good faith could be found in the record at the summary judgment stage. Having determined that the Collateral Trustee could establish a litigation reserve fund and that the series trustees were entitled to priority payment before the bondholders, the court then applied the prudent-man standard to assess the measures taken by BNY to account for the amount contained in the reserve fund. BNY argued that its actions were the result of "logical, common-sense reasoning of [its] trust officers," with its methodology and ultimate cal-

Having determined that the Collateral Trustee could establish a litigation reserve fund and that the series trustees were entitled to priority payment before the bondholders, the court then applied the prudent-man standard to assess the measures taken by BNY to account for the amount contained in the reserve fund.

the event of default, "[t]he indenture trustee shall exercise . . . such of the rights and powers vested in it by such indenture, and . . . use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."

In the case of the Continental bonds, the terms of the Indenture explicitly granted the Collateral Trustee the authority to reserve funds in its possession "sufficient to pay reasonably anticipated fees and expenses of each [series trustee] and its own fees and expenses incurred in its capacity as Collateral Trustee." In so doing, the Collateral Trustee was required to "use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."

culations the product of consultations with its Default Advisory Committee and legal counsel. The court agreed, referencing the Bank's extensive analysis, which included "soliciting fee estimates from the defendant trustees, totaling those estimates and adding 10% to cover unfor[un]seen contingencies." Moreover, the court noted the bank's argument that, "whenever there was an adequate amount of money in excess of the litigation reserve, BNY distributed that excess money" to the bondholders.

The court again cited the Court of Appeals's decision in *Matter of Bank of New York* to underscore that prudence is measured without the benefit of hindsight. It reiterated, "[a]t the time that BNY established the reserve it did not know that some of the trustees would settle with Bluebird and/or waive their fees," and could not account for the possibility that some of the series trustees' fee / continued page 8

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requests could be rejected based on their improper conduct. Rather, “BNY was not required to be prescient in making its decisions regarding the amount of money in the litigation reserve . . . it was simply required to act as a prudent man in similar circumstances.” Having established that BNY did just that, the court held that Bluebird failed to raise a material question of fact and summary judgment dismissing Bluebird’s claims was appropriate. ☺

South Dakota National Bank Denied Interest Rate in Excess of New York Usury Laws

By Francesca J. Perkins

A New York trial court has held that a national bank based in South Dakota cannot charge a New York customer interest at a rate in excess of New York’s usury limits unless it can prove that, at a minimum, at least one significant non-ministerial act associated with the account took place in South Dakota. Because the bank failed to establish this fact, it was denied interest above New York’s 25% cap. *Citibank v. Hansen*, 2010 WL 1641151 (Dist. Ct. Nassau Co. April 23, 2010).

The Facts

Defendant Jared K. Hansen, a New York resident, opened up a line of credit with Citibank (South Dakota) N.A. (“Citibank”). Citibank provided periodic written statements to defendant, setting forth each transaction in the account, together with any applicable finance and other charges.

When defendant failed to make required payments on his account, Citibank claims it made a demand for the entire balance due and owing in accordance with the terms of the credit agreement. When payment was not made, Citibank commenced suit for the balance due plus interest.

In the defendant’s pro-se answer, he included a defense that “[t]he agreement is unconscionable.” When the matter came up for trial, the defendant defaulted and an inquest was directed. By virtue of defendant’s default, the defendant’s

liability was deemed established. The court was then left to determine the applicable damages.

In support of the bank’s claim for damages, it submitted documentary evidence establishing the amount that defendant owed as of January 2009, prior to which date defendant was charged an annual percentage rate of 10%. Starting in January 2009, however, the bank’s statements began showing a substantial increase in the annual interest rate of up to 25.990%.

The Court’s Ruling

The court began by noting that it was without question that the bank was entitled to recover damages in the principal amount of defendant’s indebtedness as shown on the bank’s December 2008 statement, plus interest at New York’s statutory rate of 9%. The court went on to analyze whether the bank was entitled to recover interest at rates above New York’s 25% usury threshold. This issue turned on whether the bank, as a national banking association not based in New York, Citibank had rights under federal law to avoid the application of New York state usury limitations.

The court examined Interpretive Letter #822, issued by Comptroller of the Currency in March 1998, in which the Comptroller concluded that Congress had not completely foreclosed application of a host state’s usury laws to a national bank’s lending and credit activities. Although a national bank’s right to charge home state rates “is not defeated simply because a bank has a branch in the state where the borrower resides,” the host state’s laws and rules would apply when the host state’s branch office was the one actually ‘making the loan.’ In reviewing this and other precedent, the court concluded that “the legality [the bank’s] decision to charge ‘home state’ interest rates hinges on whether it actually conducts certain important non-ministerial functions in its home office.” Noting that interpretations of federal law by the Comptroller of Currency are ordinarily treated with deference, the court wrote, the question at issue was not whether Citibank could avoid New York’s usury laws by structuring its credit line and credit card affairs in an appropriate manner consistent with federal law. Rather, the issue was whether Citibank had in fact so structured its affairs.

The court concluded that it was unclear from the papers submitted whether “Citibank (South Dakota) N.A.” maintained any meaningful role in handling the defendant’s account after it was opened. The court observed that the national bank’s corporate parent, Citigroup, arranged for Ohio

affiliates to manage the account. There was no proof, however, suggesting that, pursuant to the criteria set forth in Interpretive Letter #822, there were any non-ministerial acts performed by Citibank from its home state offices in South Dakota.

In addition, the court found that while the bank provided a general warning in its billing statements that the interest rate “may increase,” the court was not provided with any other evidence respecting the terms of the credit agreement. As a result, the court determined that it had no way of knowing whether the increased interest rate was or was not authorized by the agreement, as written.

The court ultimately held that, based on the failure of such proof, it must decline to grant the part of the bank’s claim that sought to impose, after the January 2009 statement, interest charges above New York’s statutory pre-judgment interest rate of 9%.

Conclusion

The ruling in *Citibank v. Hansen* suggests that when a national bank intends to rely on its home state’s usury limits to the exclusion of those of other states’ limits, it will be required to shoulder a burden above and beyond simply establishing its status as a national bank. The decision suggests New York courts will require that national banks show, through admissible evidence, that at least one significant non-ministerial action associated with a challenged loan took place in the bank’s home state for the court to consider awarding usury fees above established New York state limits. ©

Originators and Intended Beneficiaries Have No Attachable Interest in Midstream Electronic Fund Transfers

By Thomas E. Butler and Kimberly Zafran

The United States Court of Appeals for the Second Circuit recently ruled that a midstream electronic fund transfer (“EFT”) temporarily in the possession of an intermediary bank

in New York may not be garnished under the Federal Debt Collection Procedures Act (“FDCPA”), 28 U.S.C. § 3206, *et seq.*, to satisfy judgment debts owed by either the originator or the intended beneficiary of the EFT. *Exp.-Imp. Bank of the United States v. Asia Pulp & Paper Co. Ltd.*, No. 09-2254-cv (2d Cir. June 22, 2010). In so holding, the Second Circuit upheld the district court’s order quashing two writs of garnishment in connection with plaintiff-appellant’s efforts to collect a \$144 million judgment against defendant-appellees.

Electronic Fund Transfers

An EFT is simply an instruction to electronically transfer funds from one account to another. The originator, the party transferring funds, will send to its financial institution an instruction to transfer funds to the beneficiary, the intended recipient of the funds. When the originator and beneficiary each have an account in the same bank, the bank will simply credit the beneficiary’s account and debit the originator’s account to effectuate the transfer. When the parties have accounts in different banks that are not members of the same wire transfer consortium, the bank uses an intermediary bank where both banks, the originator’s bank and the beneficiary’s bank, have accounts to effectuate the transfer. The originator will contact its bank when it wants to effect a transfer, and the originator’s bank will then contact the intermediary bank to perform the transfer from its account at the intermediary bank. The originators and beneficiary’s banks then adjust the accounts of their respective clients to reflect the transfer made by the intermediary bank. Significant to this analysis is the fact that, while the funds are held at the intermediary bank, they are in accounts of either the originator’s bank or the beneficiary’s bank, not in accounts of the originator or beneficiary.

The Parties

Plaintiff Export-Import Bank of the United States (“ExIm”) is a government corporation that serves as the official export credit agency of the United States. As a federal agency, ExIm’s mandate is to promote the export of domestic products, including by providing direct loans, loan guarantees, working capital guarantees and insurance promoting exportation. Defendants Asia Pulp & Paper Company, Ltd. (“APP”) and its former subsidiaries, the Principal Indonesian Operating Companies (“PIOCs”), collectively formed one of the largest paper manufacturers in the world. ExIm held over \$100 million of debt owed by defendants APP and PIOCs.

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The Dispute

Defendants PIOC's borrowed over \$100 million through ExIm's direct loan and loan guarantee programs. In March 2001, defendants announced a worldwide "standstill" on their repayment of their debt obligations, including the thirteen loans from ExIm. When PIOC's defaulted, ExIm sued for breach of contract, breach of promissory notes and breach of guarantee. The New York federal district court granted ExIm's motion for summary judgment, finding no issue of fact as to defendants' default, and awarded ExIm a judgment in excess of \$144 million. *Exp.-Imp. Bank of United States v. Pulp & Paper Co., Ltd.*, No. 03-8554, 2008 WL 465169, at *8 (S.D.N.Y. Feb. 6, 2008).

To collect on its judgment, ExIm applied for writs of gar-

The Second Circuit's Decision

The FDCPA is a federal statute that authorizes the garnishment of property in which the debtor has a "substantial interest." In affirming the district court's ruling, the Second Circuit held that whatever interest or right an originator or intended beneficiary had in a midstream EFT under New York law is insufficient to constitute a substantial interest under the FDCPA. The Court noted: "An EFT is nothing other than an instruction to transfer funds from one account to another," citing *Shipping Corp. of India Ltd. v. Jaldhi Overseas PTE Ltd.*, 585 F.3d 58 (2d Cir. 2009). In *Jaldhi*, the Court held that EFTs in the temporary possession of an intermediary bank were not subject to attachment pursuant to Rule B of the Supplemental Rules for Admiralty or Maritime Claims and Asset Forfeiture Actions of the Federal Rules of Civil Procedure ("Rule B").

The law in the Second Circuit now seems quite clear that intended beneficiaries and originators of EFTs lack any substantial interests or substantial property rights in the EFTs while they are in the possession of intermediary banks.

nishment pursuant to the FDCPA to attach property in which the defendants purportedly had an interest. The district court granted ExIm's application, and ExIm served the writs on Deutsche Bank Trust Company Americas and Bank of New York Mellon Corporation directing them to withhold all of the defendants' property in their possession. The banks responded by stating that the only property they possessed in which the defendants may have a property interest consisted of EFTs on which those banks were serving as intermediary banks. On some of the EFTs, the defendants were the originator, and on others they were the beneficiary. The defendants objected to the banks' responses asserting that (1) New York law prohibits restraint of EFTs at intermediary banks and (2) while in the possession of the intermediary banks, neither of the defendants had any property interest in the EFTs. Accepting defendants' arguments, the district court quashed the writs, and ExIm appealed.

The Second Circuit first looked to New York state law to determine what rights the defendants had in the property ExIm was seeking to reach, and then the court determined whether according to federal law the defendant's state delinquent rights constituted a "substantial interest" in the EFTs sufficient to let ExIm garnish the EFT pursuant to the FDCPA.

Relying on Article 4-A of New York's Uniform Commercial Code, the Second Circuit found:

[T]he issuance and acceptance of payment orders creates rights and obligations *only* as between the sender of the payment order and its receiving bank, between the originator's bank and an intermediary bank as to the originator's bank's payment order, between the intermediary bank and the beneficiary bank as to the intermediary bank's payment order, and finally, as between the beneficiary bank that has

accepted a payment order and that beneficiary.
(Emphasis added.)

Therefore, while they are in the possession of an intermediary bank, EFTs are neither the property of the originator nor the beneficiary. Further, because the intermediary bank is neither the legal agent of the originator nor the intended beneficiary, and because neither the originator nor intended beneficiary has any legal claim or contractual rights against the intermediary bank in the event a funds transfer is not completed, this further suggests that whatever rights or interests the defendants have in the EFTs are limited.

Based on these limitations, the Second Circuit concluded that whatever rights or interests the defendants had in the midstream EFTs under New York law were insufficient to constitute a “substantial interest.” Since neither the statutory language nor legislative history defines the phrase “substantial interest,” the Court based its interpretation of the phrase on common definitions of “substantial” and how “direct and tangible” an originator or intended beneficiary’s benefit from the property appears. The Court found that the defendants’ interests in the EFTs were not substantial, essential, or material, and the defendants did not benefit from the midstream EFTs in the same way as if they had received the money directly, and therefore they only had minimal interests in the EFTs.

Subsequent Case Law

Since issuing this decision of *Exp.-Imp. Bank of the United States v. Asia Pulp & Paper Co. Ltd.*, No. 09-2254-cv (2d Cir. June 22, 2010), the Second Circuit Court of Appeals has decided yet another case concerning the ability to attach or garnish EFTs. In *Scanscot Shipping Svcs. v. Metales Tracomex LTDA*, No. 09-5280-cv (2d Cir. August 12, 2010), the Court held, in conformity with *Jaldhi*, that “EFTs for which the defendant is both the originator and the beneficiary are not the property of the defendant, and therefore may not be attached pursuant to Rule B,” and affirmed the district court’s order vacating its order of attachment.

In *Scanscot*, the plaintiff and defendant were in the midst of arbitration proceedings when plaintiff moved for the attachment of certain EFTs held in Wachovia Bank in New York. The district court granted the motion but then ordered the plaintiff to show why the order of attachment should not be vacated in light of *Jaldhi*. The Court stated that, to be attachable pursuant to Rule B, the EFTs must be tangible or

intangible property belonging to the defendant. New York state law, however, makes it clear that EFTs in the temporary possession of an intermediary bank are not the property of either the originator or beneficiary of the EFT, and therefore the Court found that the EFTs could not be attached. The fact that the defendant was *both* the originator and the beneficiary of the EFT did not make any difference.

Impact on Midstream EFT Property Interests

The law in the Second Circuit now seems quite clear that intended beneficiaries and originators of EFTs lack any substantial interests or substantial property rights in the EFTs while they are in the possession of intermediary banks. Consequently, under New York law, attempts to garnish EFTs to satisfy a debt owed by an originator or intended beneficiary while in the possession of an intermediary bank will likely be unsuccessful. ☹

Fontainebleau Term Lenders Lack Standing to Sue Revolver Lenders

By Thomas J. McCormack and Christopher Cusmano

In a May 28, 2010 decision, Judge Alan Gold of the United States District Court for the Southern District of Florida granted a motion to dismiss claims filed against lenders on a revolving loan agreement to the Fontainebleau resort and casino project in Las Vegas. The claims were brought by two term loan lenders for the project, Avenue CLO Fund, which had provided term loan funding, and Aurelius Capital, which had acquired the interests of other term lenders following the project’s bankruptcy. The revolving loan lenders, which included JPMorgan Chase, N.A., Barclays Bank PLC, Deutsche Bank Trust Company Americas and The Royal Bank of Scotland plc, had refused to fund Fontainebleau’s initial request for funds under their credit agreement, and eventually terminated that facility. The court dismissed the claims on the grounds that the term loan lenders were not “intended beneficiaries” under revolver facility and, therefore, lacked standing to sue. *In re Fontainebleau Las Vegas Contract Litigation*, No. 09-CV-23835, No. 10-CV-20236 (ASG) (S.D. Fla. May 28, 2010).

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Fontainebleau

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The Credit Agreement

In June 2007, Fontainebleau Las Vegas LLC entered into a series of loan agreements to finance the construction and development of a resort and casino in Las Vegas: (1) a \$700 million initial term loan facility; (2) a \$350 million delay draw term loan facility; and (3) an \$800 million revolving loan facility. After receiving the proceeds of the initial term loan, Fontainebleau's access to the funds under the other facilities was subject to restrictions. Under the credit agreement, Fontainebleau could not access more than \$150 million of the revolving loan unless and until both the initial and delay draw term loans were "fully drawn." In addition, under a separate disbursement agreement, the administrative agent could issue a Stop Funding Notice terminating Fontainebleau's access to the funds if a "Default or Event of Default has occurred and is occurring."

The Dispute

In March 2009, Fontainebleau submitted a Notice of Borrowing and simultaneously sought access to both the delay draw term loan and the revolving loan. The administrative agent, Bank of America, denied this request pursuant to the credit agreement, on the grounds that the delay draw term loan was not yet "fully drawn." In fact, prior to March 2009, Fontainebleau had not requested nor received any funding under the delay draw term loan. Fontainebleau insisted, however, that the "fully drawn" requirement under the credit agreement was satisfied when the delay draw term loan was "fully requested," even though the funds were not released. Ultimately, Fontainebleau relented and amended its request, seeking access to only the delay draw term loan, which was then disbursed.

In April 2009, as the project began to face financial difficulties, Bank of America, acting as administrative agent, sent a letter to Fontainebleau providing notice that one or more "Default(s) or Event(s) of Default have occurred and are occurring," and advised that, pursuant to the credit agreement, the revolving loan commitments were being terminated by the lenders. Fontainebleau immediately requested access to the revolving loan, but this request was refused. In June 2009, Fontainebleau filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the Southern District of Florida.

The Initial Litigation

After filing the Chapter 11 petition, Fontainebleau commenced an adversary proceeding against the revolving loan lenders seeking, among other relief, an order directing the lenders to release the revolving loan funds. On a motion for summary judgment, Fontainebleau repeated its interpretation that "fully drawn" under the credit agreement meant "fully requested," and the revolving loan lenders were obligated to disburse the loan in March 2009, when both the delay draw term loan and the revolving loan were requested.

Judge Gold denied Fontainebleau's motion and concluded, as a matter of law, that "fully drawn" unambiguously means "fully funded" and not "fully requested." Therefore, the revolving loan lenders were never under any obligation to fund Fontainebleau's request for the entire revolving loan in March 2009, as the request did not comport with the credit agreement's terms.

The Current Litigation

As the Fontainebleau litigation was proceeding, Avenue CLO Fund and Aurelius Capital, as term loan lenders, filed separate lawsuits in Nevada and New York, respectively, against the revolving loan lenders. On defendants' motion to the Panel on Multi District Litigation, these claims were centralized and consolidated in the Southern District of Florida before Judge Gold. The term lender plaintiffs argued that the revolving loan lenders' failure to fulfill their obligations under the credit agreement caused the Fontainebleau casino and resort project to face financial difficulties, which harmed the term lenders' investments.

The revolver lenders moved to dismiss the claims on the ground that the term lender plaintiffs lacked standing to pursue their claims against the revolving loan lenders. As Judge Gold explained, to pursue breach of contract claims, a plaintiff must have a "legally enforceable right." This determination is made by reference to state law, and the court determined that under New York law, which applied pursuant to the credit agreement's terms, a plaintiff must be an "intended beneficiary" of a contractual promise to sustain an action for breach of that contract. Unless the plaintiffs could demonstrate they were "intended beneficiaries" of the revolving loan lenders' promises under the credit agreement, the court explained, they lack standing to sue the revolving loan banks.

The court's analysis began with the intentions of the parties, as expressed in the plain language of the credit agreement. According to the court, the language was unambiguous

as the credit agreement stated that the revolving loan lenders agreed to make loans to “borrowers.” Thus, the language imposed a contractual duty on the revolving loan banks only in favor of Fontainebleau, as borrower. Nothing in the credit agreement created a similar duty in favor of the term lender plaintiffs, nor suggested any intention of the parties to permit the term lenders to enforce the credit agreement.

Although the term lender plaintiffs would have probably benefitted if the revolving loan banks did fund Fontainebleau’s request, the court found that, at most, this demonstrates that the term lenders were “incidental beneficiaries” under the credit agreement. As a result, the term lender plaintiffs have no “legally enforceable right” and lack standing to pursue claims against the revolving loan banks.

The court also noted that, even if the term lender plaintiffs had standing, they could not demonstrate that the revolving lenders breached the credit agreement. Echoing his previous opinion in the *Fontainebleau* litigation, Judge Gold reiterated that the plain meaning of “fully drawn” in the credit agreement means “fully funded” and not “fully requested.” Since Fontainebleau requested the revolving loan funds before the delay draw term loan was “fully drawn,” there was no breach of the credit agreement by the revolving lenders.

The court did refuse to dismiss a separate breach of contract claim against Bank of America, as administrative agent, for allegedly disbursing the delay draw term loan after allegedly receiving notice of a default by another Fontainebleau lender, as well as notice of other potential problems related to the financing of the casino and resort project. ©

Bank’s Internal Practices Do Not Alter Mortgage Terms

By Robert Grossman

On May 28, 2010, an Ohio state appeals court reversed a trial court’s decision granting summary judgment in favor of the Federal Deposit Insurance Corporation (“FDIC”), as Receiver of Washington Mutual Bank (“Washington Mutual”), which had entitled the FDIC to a judgment of foreclosure. *Fed. Deposit Ins. Corp. v. Traversari*, 2010 Ohio 2406, 2010 Ohio App. LEXIS 1992 (Ohio Ct. App., Geauga County, May 28, 2010). The appellate court held that Washington Mutual had no right to foreclose based on the mortgagor’s failure to render payment in a

manner consistent with Washington Mutual’s internal practices, where such practices were not specified in the parties’ loan agreement.

Background

In 1994, the mortgagor borrowed \$190,000 from Loan America Financial Corporation, the original lender. This loan was secured by a mortgage on certain real property in Ohio. Loan America Financial Corporation subsequently assigned this loan to Washington Mutual. On January 8, 2007, Washington Mutual filed a foreclosure complaint against the mortgagor asserting that the mortgagor was in default of his loan and owed Washington Mutual over \$150,000 in principal and interest.

The mortgagor asserted a counterclaim against Washington Mutual in which it asserted that Washington Mutual was estopped from foreclosing because it had waived acceptance of payment. In particular, the mortgagor maintained that he had previously sent three separate checks to Washington Mutual, each of which would have satisfied the loan. According to the mortgagor, Washington Mutual did not cash or otherwise respond to the first two checks, and it responded to the third check only by returning it to the mortgagor with a message advising that Washington Mutual did not accept personal checks in repayment of loans. While Washington Mutual disputed that it had received all three of the checks cited by the mortgagor, it admitted to returning one such check to the mortgagor because of Washington Mutual’s “policy not to accept checks for early payoffs that are not certified funds.”

On July 3, 2008, the trial court ruled that Washington Mutual could refuse to accept personal checks in accordance with its internal policy and, on August 8, 2008, it issued a summary judgment order that entitled Washington Mutual to foreclosure. The mortgagor appealed.

The Appellate Court’s Ruling

The appellate court acknowledged that a mortgagee is estopped from claiming a mortgage has been breached where a mortgagor tenders full payment of a mortgage without condition, and the mortgagee refuses to present the mortgage for payment and cancellation. It noted further that this estoppel claim stems from the implied condition of every contract that one party will not impede the other’s performance.

The court acknowledged that Washington Mutual rejected the mortgagor’s personal checks only / continued page 14

Mortgage Terms

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because of its “policy . . . to require mortgagors to pay by certified check for any amounts over \$5,000.” Because the mortgagor’s tender of personal checks was not precluded by the terms of the mortgage, however, it held that Washington Mutual had no right to apply these internal practices to this loan. The court noted further that the mortgage actually imposed an obligation on Washington Mutual to apply payment when tendered, without imposing any limitation with respect to personal checks. Washington Mutual thus appeared to have violated the mortgagor’s rights.

Washington Mutual argued that it was justified in relying on its internal policy of requiring certified checks because it can take up to ten business days for a personal check to clear. However, the court found that this was not an undue burden because, under Ohio law, a mortgagee has up to 90 days to verify the sufficiency of a payment before satisfying and releasing a mortgage.

Accordingly, the court held that the mortgagor had stated a viable counterclaim and the trial court erred in granting FDIC’s motion for summary judgment. The court declined to issue in order granting summary judgment in the mortgagor’s favor, however, because a genuine issue of fact remained regarding whether the mortgagor’s checks were sufficient to satisfy his entire obligation under the mortgage.

Implications for Lenders

Although *Traversari* dealt with a seemingly insignificant mortgage, lenders should be mindful of its holding as it may stand for a broader proposition that lenders cannot rely on any of their internal practices or policies to impose obligations on borrowers that are not expressly set forth in the loan agreement. ☺

Court Applies “Imposter Rule” and Dismisses Claims Against Banks for Improper Payment on Forged Checks

By Emily Abrahams

In *Tripp & Co. Inc. v. The Bank of New York (Del.) Inc. n/k/a. BNY Mellon Trust of Delaware, N.A., and Citibank (South Dakota) N.A.*, 2010 WL 2836999 (Sup. Ct. N.Y. Co.) (Jul. 14, 2010), a case decided in the Commercial Division of the New York State Supreme Court, the court dismissed all of the claims brought by plaintiff Tripp & Co., Inc. (“Tripp”) against defendants Citibank, N.A. (“Citibank”) and The Bank of New York (Del.), Inc. (“BNY”) in connection with a fraudulent check scheme perpetrated by Tripp’s employee, Michael Axel. The eight claims brought by Tripp sounded in conversion, gross negligence and negligence. In dismissing the conversion claims, the court relied upon Section 3-405 of the Uniform Commercial Code (“UCC”), also known as the “imposter rule,” which shifts the risk of loss from depositor or drawee banks to the drawer of the checks. The common law claims for negligence and gross negligence were dismissed because of the existence of applicable UCC provisions.

Background

As a small brokerage firm, Tripp engaged clearing service Pershing, LLC (“Pershing”) to maintain its customers’ assets in a brokerage account. When Tripp needed to issue a check to one of its customers, Tripp would make a request to Pershing and Pershing would issue checks payable to Tripp’s customers from Pershing’s account. Pershing’s account was managed by defendant BNY. As part of Axel’s employment at Tripp, he was authorized to make check requests to Pershing on behalf of Tripp’s customers. Axel’s authority to make those check requests is what enabled him to perpetrate his fraudulent scheme. Specifically, Axel would make check requests to Pershing on behalf of Tripp’s employees, inscribe on the check “Pay to Michael Axel,” forge the payees’ names, and then cash or deposit the checks into his personal bank account at defendant Citibank. Citibank accepted the deposits and made payments on the checks and BNY accepted and cleared the checks.

Axel made 220 fraudulent check requests over five years, resulting in the misappropriation of over \$624,000. Through receipt of funds from its insurance company and a plea agreement with Axel, Tripp was able to recover \$624,000 and reimburse its customers. Ultimately, however, Tripp was unable to recover from the customer disruption caused by Axel's fraud and went out of business.

The General Rule v. The Imposter Rule

In general, for improper payment of a forged indorsement, the risk of loss is imposed upon the drawee bank. *Tripp*, 2010 WL at *2, citing UCC §1-201[43] (McKinney 2010); UCC §3-401 (McKinney 2010). Applied to the facts of this case, that general rule would have imposed liability on BNY, as drawee (or even Citibank, as depositor). Section 3-405 of the UCC, also called the imposter rule, however, shifts the risk of loss from the banks to the drawer of the checks. Section 3-405 provides that “[a]n indorsement by any person in the name of a named payee is effective if . . . the agent or employee of the maker or drawer has supplied him with the name of the payee intending the latter to have no such interest.”

The principle behind the imposter rule is that the drawer of the check is in a better position to detect a fraud by one of its agents or employees than the drawee or depositor bank. Moreover, businesses can purchase insurance coverage to protect against losses caused by their employees' commission of a fraud. The Official Comment to Section 3-405(i)(c), cited by the court, provides:

The principal followed is that the loss should fall upon the employer as a result of his business enterprise rather than upon the subsequent holder or drawee. The reasons are that the employer is normally in a better position to prevent such forgeries by reasonable care in the selection or supervision of his employees, or, if he is not, is at least in a better position to cover the loss by fidelity insurance; and that the cost of such insurance is properly an expense of his business rather than of the business of the holder or drawee.

In this case, the drawer of the check was non-party Pershing. The fact that Axel was employed by Tripp and not by Pershing, however, was not an impediment to the court's application of Section 3-405. Instead, the court reasoned that Axel was an agent of Pershing, the drawer of the checks, thus making the imposter rule applicable. The court held:

Pershing and Axel had a 'well-established course of dealing' lasting for at least five years, in which Axel supplied the payee information so that Pershing could simply draw the checks. [T]he action of supplying payee information on behalf of a brokerage firm to its clearinghouse is very much 'normal business practice' of an employee. Axel, as an agent of Pershing (the drawer), supplied the names of the payees, intending the latter to have no such interest, such that the imposter rule applies and the indorsements are legally effective.

Although the court's application of the imposter rule focused on the relationship between Axel and Pershing and the well-established course of dealing among the parties, the court did not lose sight of the fact the fraud was covered by an insurance policy. The court held: “The facts here make application of the rule reasonable. Tripp was in a position to prevent the fraud in its hiring and monitoring of Axel and actually collected on an insurance policy that covered Axel's fraudulent conduct—an insurance policy that is properly a business expense of Tripp's rather than of the holder or drawee.”

No Duty of Care Owed by Banks

Characterized as a “banker's provision,” the imposter rule not only shifts the risk of loss from the depositor or drawee bank to the drawer (or employer), but the rule will render fraudulent indorsements legally effective *even if* the depositor or drawee bank acted in a commercially unreasonable manner. Put simply, “Section 3-405 imposes no duty of care.” As such, according to the court, Tripp's suggestion that “the quantity and double-indorsed nature of the checks, frequency of deposits, and amount and duration of the fraud” should have caused the defendants to investigate, was insufficient as a matter of law. Indeed, the court noted that while the imposter rule does not protect banks from claims of commercial bad faith, i.e. knowing participation in a fraudulent scheme, “‘wary vigilance’ [or] even ‘suspicious circumstances which might well have induced a prudent banker to investigate,’ would be insufficient to state a cause of action against a depository bank.”

Common Law Claims Pre-Empted by UCC Claims

The court dismissed Tripp's common law claims for negligence and gross negligence because of the existence of applicable provisions of the UCC, noting that / *continued page 16*

“Imposter Rule”

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“[a] plaintiff may not ‘sidestep’ the UCC by merely attempting to restate a failed UCC claim as a common law cause of action.” The sole exception to that rule, as explained by the court, applies when a bank neglects a restrictive indorsement provision, for example, an indorsement “for deposit only.” Finding that defendants Citibank and BNY “deposited and withdrew the checks in full compliance with the drawer’s instructions,” that narrow restrictive indorsement exception did not apply. ☉

Mortgage Servicer Can Sue in Own Name as Real Party in Interest

By Thomas J. Hall and Benjamin D. Bleiberg

The United States Court of Appeals for the Seventh Circuit recently reversed a district court decision that had dismissed claims by a mortgage servicer seeking to recover settlement payments made in satisfaction of unpaid rent by a commercial property tenant to the mortgageor. *CWCapital Asset Management, LLC v. Chicago Properties, LLC*, No. 09-3506, 2010 U.S. App. Lexis 13229 (7th Cir. June 29, 2010). The Court found that, pursuant to the terms of the parties’ Pooling and Servicing Agreement, the mortgage servicer could sue in its own name as a real party in interest. While finding that the mortgage servicer had standing, the Court went on to dismiss the servicer’s claims on the merits pursuant to the terms of the parties’ Subordination, Non-Disturbance and Attornment Agreement and the mortgage note.

Background

Plaintiff CWCapital Asset Management, LLC (“CWCapital” or the “Servicer”), was a mortgage servicer for the LaSalle Bank National Association, the Trustee for a trust (the “Trust” or “Mortgagee”) holding a \$618,000 mortgage note (the “Mortgage Note”) executed by Insite Chicago (Addison/Milwaukee), LLC (“Insite”). The Mortgage Note granted the Trust a first priority security interest in certain commercial property located in Chicago (the “Property”). CWCapital’s specific responsibilities relating to the Mortgage Note were dictated by a

Pooling and Servicing Agreement (“PSA”) with the Trustee.

Beginning in 1999, Insite leased the Property to Blockbuster, Inc. (“Blockbuster”), a national chain of movie rental stores. As part of the lease to Blockbuster (the “Lease”), Blockbuster executed a Subordination, Non-Disturbance and Attornment Agreement (“SNDA”) between itself, as the tenant; Insite, as the mortgageor; and the Trust, as the Mortgagee. The SNDA required Blockbuster to pay rent directly to the mortgagee upon written demand, prohibited payment of rent more than one month in advance, and required prior written consent from the Mortgagee for any amendments or modifications to the lease that reduces its term or the tenant’s monetary obligations. In 2002, Chicago Properties, a commercial landlord, became the mortgageor when it assumed all of Insite’s obligations under the Mortgage Note, and Chicago Properties’ owners became guarantors of the Mortgage Note (the “Guarantors”).

Unable to make a profit at the location due in part to increasing competition from direct mail movie rental companies, movie rental vending machines, and Internet and cable-based movie streaming, Blockbuster abandoned the Lease and vacated the Property by July 2006. Chicago Properties subsequently filed suit against Blockbuster, which allegedly owed approximately \$470,500 in rental payments for the time remaining on the Lease, and they soon after agreed to a settlement. Blockbuster would pay the Guarantors approximately \$161,000 (the “Settlement Payment”) in exchange for an agreement to terminate the Lease and release all claims against it (the “Settlement Agreement”). When Blockbuster and Chicago Properties notified CWCapital of the proposed terms, CWCapital and the Trustee objected to them on the grounds that it would decrease the collateral value of the loan.

Despite CWCapital and the Trustee’s protests, Blockbuster wired the Settlement Payment to the Guarantors, and Chicago Properties released Blockbuster from its Lease obligations. CWCapital subsequently sent letters to Blockbuster and Chicago Properties demanding that Blockbuster continue to make payments directly to the Trust, and that Chicago Properties give CWCapital any additional payments Blockbuster had made in excess of the monthly rent. During this time, Chicago Properties continued to make full and timely payments on the Mortgage Note, despite being unable to find a substitute tenant after Blockbuster’s departure.

When Blockbuster and Chicago Properties failed to follow CWCapital’s demands, the Trust declared an event of default. Suing in its own name in the United States District Court for

the Northern District of Illinois, CWCapital filed a complaint against Chicago Properties, the Guarantors, and Blockbuster (collectively, the “Defendants”). CWCapital alleged that it was contractually entitled to the Settlement Payment, plus attorneys’ fees, because the Defendants had breached the Mortgage Note, the guaranty, and the SNDA when they modified the Lease without consent and agreed to exchange more than one month of rent in advance. The Defendants filed counterclaims against CWCapital, and Blockbuster filed cross-claims against Chicago Properties and the Guarantors.

After a two-day bench trial, the district court held that CWCapital’s contract claims were meritless, but dismissed the suit on the grounds that CWCapital lacked standing to sue because it failed to establish that it was a real party in interest as a servicer. An appeal to the Seventh Circuit followed.

The Seventh Circuit’s Standing Decision

On appeal, Circuit Judge Richard Posner, writing for the majority, reversed the lower court’s holding. The Court first found that pursuant to the terms of the PSA, CWCapital had standing as a servicer to sue in its own name as a real party in interest. Generally, servicers are tasked with collecting the borrower’s monthly principal and interest payments; ensuring that the property is properly insured; discharging the mortgage when it is paid off; and acting as the mortgagee’s collection agent in addressing defaults by suing the borrower, foreclosing, or modifying the terms of the mortgage. The Court analogized that a servicer’s standing may be similar to that of an assignee for collection, which has standing to sue in its own name to recover money for the assignor, depending on the specific contractual arrangement between the servicer and the mortgagee. The Court reasoned that servicers and assignees have a personal stake in the outcome of a collection lawsuit because they receive a percentage of the proceeds from the defaulted loans that they service. If the contractual arrangement between the servicer and the mortgagee was merely a power of attorney, and the servicer’s role was akin to an attorney who does not have authority to sue as real party in interest, the servicer would have no standing.

Accordingly, the Court examined the PSA to determine whether CWCapital’s role was that of an assignee for collection or merely an attorney. Although the PSA failed to explicitly state whether CWCapital had the same standing as an assignee for collection, the Court found that three provisions in the PSA delegated “what is effectively equitable ownership

of the claim . . . to the servicer,” and that CWCapital could sue in its own name.

First, the PSA stated that the Servicer “shall . . . have full power and authority, acting alone, to do or cause to be done any and all things in connection with such servicing and administration which it may deem necessary or desirable.” The Court interpreted this provision to include the authority to sue. Second, the Trustee shall at the Servicer’s “written request . . . promptly execute any limited powers of attorney and other documents furnished by the [Servicer] . . . that are necessary or appropriate to enable [the Servicer] to carry out [its] servicing and administrative duties hereunder.” The Court held that the mandatory language of the provision *required* the Trustee to grant CWCapital whatever authority it needed to service the Mortgage Note. Finally, the PSA provided that “except as relates to a Loan that the . . . Servicer . . . is servicing pursuant to its respective duties herein (in which case such servicer shall give notice to the Trustee of the initiation), [the Servicer shall not] initiate any action, suit or proceeding solely under the Trustee’s name without indicating the . . . Servicer’s . . . representative capacity” without the Trustee’s written consent. The Court found that this language indicated that CWCapital may sue in its own name.

The Court further held, in the alternative, that even if CWCapital was not the real party in interest, it could still sue because the Trustee submitted an affidavit that ratified CWCapital’s suit on the Trustee’s behalf. Rejected as untimely by the lower court because CWCapital failed to respond to an interrogatory regarding its authority to sue, the Seventh Circuit found that the affidavit was timely submitted in response to the Defendants’ motion for judgment on the pleadings regarding the standing issue.

Decision on the Merits

After finding that the Servicer had standing, the Seventh Circuit, however, ultimately directed the lower court to enter judgment for the Defendants on the merits. The Court found that there was no event to trigger Blockbuster’s requirement to pay CWCapital pursuant to the SNDA because Chicago Properties continued to pay monthly mortgage payments in full, CWCapital was not injured by not receiving payments directly from Blockbuster, and there was no evidence that Blockbuster’s failure to pay CWCapital directly reduced the value of the Property.

The Court further held that the Settlement Agreement did not breach any provisions concerning / continued page 18

Mortgage Servicer Standing

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payment of rent in advance in the SNDA, Mortgage Note, or guaranty. The money that Blockbuster paid the Guarantors was not a rent payment. Instead, it was a payment to settle a lawsuit for rent payments for the term remaining on Blockbuster's lease. Additionally, Chicago Properties did not breach the Mortgage Note's prohibition against cancelling the Lease without the Mortgagee's written consent because the Mortgage Note included an exception for cancellations made when the borrower "is acting in the ordinary course of business and in a commercially reasonable manner." The Court found that Chicago Properties was commercially reasonable to reach the Settlement Agreement with Blockbuster in consideration of Blockbuster's financial situation.

Implication for Mortgage Servicers

The *CWCapital Asset Management* case illustrates the importance of unambiguous contractual language. Although the Seventh Circuit found that the Servicer's arrangement here allowed the Servicer to sue in its own name as a real party in interest, the substitution of more ambiguous contractual language could have led to a different outcome entirely—potentially leaving the Servicer without legal recourse. ☺

Trifurcation of Trial Results in Reversal of Gross Negligence Finding Against Accounting Firm

By Maureen Schad

Background

In 2004, Banco Espirito Santo International and two of its affiliates (collectively, "Banco") sued BDO Seidman, L.L.C. ("BDO"), an international accounting firm, claiming that BDO negligently audited one of its former clients, E.S. Bankest L.L.C. ("Bankest"), which had perpetrated a loan-fraud scheme against Banco. The suit alleged that BDO "rubberstamped" Bankest's financial statements, leading to Banco's loss of \$170 million from bogus factoring loans. A criminal case charging

Bankest with bank fraud, falsifying financial statements, and other offenses related to its use of fictitious invoices and sham companies led to four convictions in 2006, including that of Bankest's former president, who was subsequently sentenced to 20 years in prison.

The Trial Court's "Trifurcation" Order

In the civil case against BDO, the parties had not requested that the trial be bifurcated into two distinct phases of liability and damages. Nevertheless, the trial court decided to try the case in phases. The court determined that the jury would first hear and decide the issue of whether BDO breached its professional duties to its former client, the non-party Bankest. Second, the jury would next hear and decide whether BDO's duties extended to Banco and, if so, whether Banco relied on BDO's audit reports and whether BDO breached its duty. Thereafter, if the jury found both duty and breach of duty, a damages trial would follow.

Ultimately, the trial court decided that the case would be tried in three phases. In phase one, the jury heard and determined only the question of whether BDO was "personally guilty of gross negligence." Having found against BDO in the first phase, in the second phase the jury heard and determined issues of causation and comparative fault. Thus, the jury's determination of whether BDO was "personally guilty of gross negligence" was made without consideration of BDO's specific allegations of comparative fault—including failures to report or act—on the part of the Banco parties and several third-party actors. In addition, during the second phase the jury heard and determined the issue of compensatory damages, awarding Banco over \$159 million in compensatory damages, as well as Banco's entitlement to recover punitive damages, but not the amount thereof. Having determined in the second phase that a punitive damages award was appropriate, the jury then proceeded to the third trial phase to quantify the punitive damages award at over \$351 million. BDO appealed.

The Appellate Decision

In June 2010, Florida's Court of Appeal reversed and remanded the case for re-trial. *BDO Seidman v. Banco Espirito Santo International et al.*, Nos. 3-D09-324, 09-197, 07-2746, 07-2472 (Fla. Dist. Ct. App., June 23, 2010). In its 20-page decision written by Judge Salter, the appellate court held that the lower court's decision to "trifurcate" the trial into three distinct phases impermissibly allowed the jury to render a verdict on

BDO's liability for gross negligence before it ever considered the intertwined and critical issues of comparative fault, reliance, and causation.

The court recognized that several important objectives can be served by bifurcation of liability and damages, that often justify a trial court's exercise of discretion in ordering these two distinct phases. Judicial economy is served, for example, when the need for a damages hearing is obviated by a defense verdict, or when a larger case is reduced into more easily digestible phases. Here, however, despite the trial court's good intentions, trifurcation did not advance any such objectives. In this complex case, the court explained, with plaintiffs not in privity with the defendant accounting firm, liability turns on evidence of knowledge, intent, and reliance, and involves consideration of the "inextricably intertwined" issues of comparative fault, causation and gross negligence. By allowing the jury to determine prematurely the issue of gross negligence, without first hearing any evidence on comparative fault or causation, the trial court's trifurcation order severely prejudiced BDO.

Gross Negligence and Punitive Damages

Turning to the punitive damage award, the appellate court explained that under Florida law, punitive damages are intended to punish a defendant for "gross and flagrant negligence," or conduct which is "committed with such gross negligence as to indicate a wanton disregard for the rights and safety of others." As codified by the Florida Legislature, the definition of "gross negligence" is substantially similar: conduct "so reckless or wanting in care that it constituted a conscious disregard or indifference to the life, safety or rights of persons exposed to such conduct." Fla. Stat. § 768.72(2)(n) (2007). The Court of Appeal noted that the standard jury instructions on punitive damages, which include this same definition and which were given in this case, further highlight the link between the two concepts.

Although the term "punitive damages" was not included in phase one of the trial, the appellate court underscored that by the time the trial proceeded to the second phase, the jury had already found the factual predicate for such damages. It had already determined, by clear and convincing evidence, that BDO was "guilty" of gross negligence—negligence rising to the level of conscious disregard for the rights of others. Indeed, in the second phase of the trial argument, Banco's counsel reminded the jury that they had already reached this conclusion, and argued that BDO's evidence and argument on

causation in the second phase should be rejected as it directly contradicted the jury's phase one verdict.

Therefore, the Court of Appeals explained, by the time the trial entered phase two, the jurors had already "rendered a verdict of 'guilt' reflecting their 'firm belief or conviction, without hesitation' that BDO was so reckless or wanting in care that its acts and omissions 'constituted a conscious disregard or indifference to the rights of persons exposed to its conduct.'" The Court of Appeals disagreed that the jury could adequately determine such an issue without considering all of the evidence on causation and comparative fault.

The Court of Appeals distinguished several cases cited by Banco, including those approving bifurcation in class action suits. Not only was the class action context not analogous to the present case, the court noted, but in one case, Florida's Supreme Court in fact held that a determination of entitlement to punitive damages during phase I was premature. In conclusion, the court held, a "gross negligence" finding "should be based upon a thorough consideration of all the evidence bearing on causation, reliance and comparative fault. In this case, some of that evidence was not admitted until well after a verdict of gross negligence already had been rendered."

Remand for a "Streamlined, Two-Phase" Trial

The court noted that the trifurcated trial had at least identified various evidentiary disputes that could be properly resolved in a pretrial conference on remand and in a "streamlined, two-phase" trial. The decision clearly set out these two "streamlined" phases: in phase I, all issues, including Banco's entitlement to punitive damages, should be determined; then, should the jury approve the award of punitive damages, the amount of such damages would be determined in phase II.

The court acknowledged the extensive time commitment made by both the jury and judge and emphasized that it had carefully considered "every substantive and procedural authority" in an effort to find some way to preserve at least some of the jury's findings. "In this case, however," the court wrote, "no such balm is to be found. The fact issues are, to use that word that frustrates bifurcation, 'intertwined.' The cart cannot lead the horse." ☺

Lender Has No Obligation to Negotiate Restructuring of Loan Affected by Economic Crisis

By Andrea Voelker

A New York trial court recently held that, absent an express contractual requirement, lenders are under no obligation to negotiate new terms with borrowers and guarantors in default due to the current economic crisis. *KBS Preferred Holding I LLC v. Petra Fund REIT Corp.*, 601384/09 (N.Y. Co. May 3, 2010). Specifically, the court found that the lender had no obligation to negotiate the restructuring of a debt despite the fact that the borrower and guarantor were alleged to be deeply affected by the economic downturn. Evidencing the court's unwillingness to read implied obligations into financial contracts, borrowers and lenders should read this decision as keeping the status quo of financial contracts despite an ever-changing economic backdrop.

Background

In 2007, plaintiff KBS Preferred Holding I ("KBS") made a \$50 million loan to defendant Petra Fund REIT Corp ("Petra REIT") that was secured by two promissory notes and guaranteed by defendant Petra Offshore Fund, L.P. ("Petra Offshore," collectively with Petra REIT, the "Funds"). The Funds, which invest, structure and trade debt in the real estate market, allegedly failed to make any payments under the loan agreement, notes or guaranty (collectively the "Loan Documents"), allegedly due to the economic crisis. Two separate lawsuits ensued.

In the first action (the "KBS Action"), KBS filed a motion for summary judgment in lieu of complaint pursuant to Section 3213 of the New York Civil Practice Law and Rules, seeking recovery of the loan balance. The Funds brought a separate action (the "Funds Action") in which they sought declaratory judgments that KBS breached the loan agreement by acting unreasonably, that KBS breached the covenant of good faith and fair dealing implied in the loan agreement, and that performance under the loan agreement was rendered impossible due to the economic crisis. As these claims coincided with the Funds' defenses to the KBS Action, the Funds responded to KBS' motion for sum-

mary judgment in lieu of complaint by filing a cross-motion to consolidate the KBS Action with the Funds Action.

The Motion to Consolidate

The Funds moved for consolidation on the grounds that the Funds Action had the same parties, agreements and questions of law as the KBS Action, that consolidation would serve judicial economy and would best preserve the parties' resources, and that the Funds would have asserted the claims in the Funds Action as defenses or counterclaims in the KBS Action had they been permitted to do so under the Loan Documents, which prohibited the assertion of non-compulsory counterclaims. KBS' main argument in opposition was that consolidation would delay the accelerated procedure contemplated by Section 3213 for recovery on instruments for the payment of money only.

The Funds' Claims and Defenses

The Funds' defenses to the KBS Action were reflected in the declaratory judgments sought in the Funds Action. With regards to the first declaration sought, the Petra Funds relied on Section 30 of the loan agreement to support their claim that KBS acted unreasonably. Section 30 provided:

In the event that a claim or adjudication is made that Lender or its agents have acted unreasonably or unreasonably delayed acting in any case pursuant to the provisions of Section 21 or 22 hereunder where by law or under this Agreement or the other Loan Documents, Lender or such agents, as the case may be, has an obligation to act reasonably or promptly. Borrower agrees that neither Lender nor its agents shall be liable for any monetary damages, and Borrower's sole remedies shall be limited to commencing an action seeking injunctive relief or declaratory judgment. The parties hereto agree that any action or proceeding to determine whether Lender has acted reasonably shall be determined by an action seeking declaratory judgment. Borrowers hereby waive their right to assert a counterclaim, other than a compulsory counterclaim, in any action or proceeding brought against [sic] Lender or its agents.

Section 21 of the Loan Agreement referenced in Section 30 above gave the lender the right to include information about the loan and the borrower in its public filings to the extent "in its reasonable judgment" such disclosures were necessary to

comply with securities laws. Section 22 referenced therein, obligated the borrower to perform further actions and execute such documents “as the lender may reasonably request.” It was from these narrow obligations on the lender to act reasonably that the Funds alleged that, in light of the financial crisis, KBS acted unreasonably by not negotiating to restructure the debt and by allegedly not considering a proposal to transfer certain assets of the Funds to KBS.

As to the second declaratory judgment sought, the Funds claimed KBS breached the implied covenant of good faith and fair dealing by (1) intentionally preventing performance by the Funds; (2) declaring the Funds in default despite the economic crisis; (3) declaring the Funds in default despite the fact that the Funds were attempting to reorganize their debts with KBS and with their other lenders; and (4) unreasonably reject-

Funds’ impossibility defense, KBS contended that, not only was the argument without legal merit, but flawed as the Funds’ inability to pay the debt was fueled by their own poor financial decisions, rather than just adverse market conditions.

The Legal Structure

Under Section 3213, which allows for commencement of an action by summary judgment rather than through a complaint where the plaintiff is suing on a instrument for the payment of money only, such as a promissory note, a plaintiff can establish a prima facie entitlement to judgment as a matter of law by demonstrating that (1) the borrower defaulted and (2) the guarantor failed to meet its obligations. Since these facts were not disputed by the Funds, KBS had established a prima facie case, and the burden shifted to the Funds

Specifically, the court found that the lender had no obligation to negotiate the restructuring of a debt despite the fact that the borrower and guarantor were alleged to be deeply affected by the economic downturn.

ing the Funds proposal that KBS purchase certain assets. The Funds sought a third declaratory judgment, that their performance under the Loan Documents was rendered impossible due to the economic crisis.

In response to these arguments, KBS argued that the loan agreement did not contain any pre-conditions and did not compel KBS to negotiate with the Funds in the instance of KBS declaring that the Funds were in default. Specifically, KBS asserted that Section 30 was for KBS’ protection and limited the remedies available to the borrower, rather than imposing obligations on KBS in the event of the borrower’s default. KBS also argued that the Funds’ defense of a breach of the implied covenant of good faith and fair dealing was not supported by law, as the Funds had already received the benefits of the contract, and KBS did in fact negotiate a possible restructuring with the Funds, albeit unsuccessfully. Lastly, regarding the

to establish “a triable issue of fact relative to a bona fide defense.”

For the Funds to establish the defense that KBS breached the contract by acting unreasonably, they were first required to establish that the loan agreement included an obligation on KBS to act reasonably. Regarding the Funds’ allegation of a breach of the implied covenant of good faith and fair dealing, the Funds could establish a triable issue of fact for this defense only by showing that KBS acted in a manner so as to deprive the Funds the right to receive benefits under the agreement. Because the contract also involved an exercise of discretion in certain instances, the court stated that the implied covenant of good faith and fair dealing could also be breached if the Funds could show KBS acted “arbitrarily or irrationally exercising that discretion.” No implied obligation will be found, however, unless it is consis- / *continued page 22*

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tent with the other terms of the contract. Lastly, regarding the defense of impossibility, the court stated this defense would excuse the Funds' performance only if they could demonstrate "the destruction of the subject matter of the contract or [that] the means of performance makes performance objectively impossible."

The Court's Ruling

Before deciding the merits of the two actions, the court first denied the Funds' cross-motion to consolidate, while consolidating the actions in the opinion for disposition. In ruling so, the court emphasized the fact that the parties to the contract were "sophisticated commercial parties," and that Petra REIT freely agreed to the waiver in the Loan Documents of its right to assert non-compulsory counterclaims in any action by KBS to recover under the loan agreement. The court also noted that consolidation would cause delay, was unnecessary and would prejudice KBS as it would be deprived of the acceleration afforded by Section 3213.

Turning to the KBS Action, the court then considered the defense of breach of contract. Looking at Section 30 of the loan agreement, the Court found that the clear and unambiguous language imposed no additional obligations on KBS. The court stated that, even if the contract did require KBS to negotiate for the restructuring of the Funds' debt, there was no basis in the Loan Documents to conclude that negotiations between the parties had to be successful for such contractual obligation to be satisfied. Based on these facts, the court concluded that there was no triable issue of fact regarding the Petra Funds' breach of contract defense based on unreasonableness.

Regarding the claim that KBS breached the implied covenant of good faith and fair dealing, the court held that the Funds failed to show a breach, explaining that "[t]he court does not accept the argument that sophisticated business entities would be justified in presuming that, in the event of default, the Lender would be obligated to restructure the Borrower's and Guarantor's obligations on those terms deemed acceptable by the Borrower and Guarantor."

The court similarly struck the Funds' impossibility defense, citing the case *Pettinelli Elec. Co., Inc. v. Board of Educ. of City of New York*, 56 A.D.2d 520 (1st Dep't 1977), where the Appellate Division held that "financial difficulty or economic hardship, even to the extent of insolvency or bankruptcy, is not such

impossibility as to excuse a defendant from liability in damages for failure to perform the contract." Additionally, the court noted that the Funds were trying to excuse themselves not from performance of a contract but rather payment of a debt, and pointed to the case *University of Minnesota v. Agbo*, 176 Misc. 2d 95 (2d Dep't 1998), where the court held that "the defense of impossibility of performance only excuses the performance of an executory contract," and "has never been held available for the purpose of unjustly enriching one party at the expense of the other." Based on the Funds' inability to set forth a triable issue of fact for any of its defenses, the court granted KBS' motion for summary judgment in lieu of complaint.

Lastly, the court granted KBS' motion to dismiss the Funds Action. The court held that no actual controversy existed with regards to the Loan Documents because, as stated previously, KBS had no obligation to restructure the Petra Funds' loans. Additionally, the court restated that the Funds had not pleaded a defense of a breach of the contract, that it had not pleaded a defense of a breach of the implied covenant of good faith and fair dealing, and it had not pleaded a proper declaratory judgment claim regarding the issue of impossibility.

Conclusion

While the economic crisis may have affected the borrower's and guarantor's ability to repay the loan documents, it did not change their responsibilities as borrower and guarantor, nor did it add defenses available for their breach. As such, where a prospective borrower or guarantor would like to require the lender to negotiate in good faith for the restructuring of their debt in the event of adverse economic developments, these parties should specifically contract for such an obligation, as a court is unlikely to read them into a contract. Additionally, while it is improbable that a court will read this obligation into a contract, lenders may be able to prevent litigation on the subject by making the contractual language clear about the lender's obligations or lack of obligations under the contract. ☺

Credit Issuer Exposed to Truth In Lending Act Class Action for Inadequate Credit Card Disclosure Statement

By *Marcelo Blackburn*

As a consumer, you may not have carefully scrutinized the disclosure statements that accompanied your credit card accounts. As a credit issuer, however, you ignore the details of your disclosure statements at your peril. A recent federal district court decision in *Taub v. Big M Inc.*, No. 09 Civ 10592 (S.D.N.Y. June 23, 2010), found that the disclosures contained in a retail store credit agreement violated the Truth in Lending Act, 15 U.S.C. § 1601, *et seq.* (“TILA”), and its implementing regulation, 12 C.F.R. § 226 (“Regulation Z”). As a result, the court denied the defendant’s motion to dismiss the class action complaint. Notably, the *Taub* plaintiff and her lawyers have filed at least one other class action complaint asserting TILA violations against another credit card issuer. *See Taub v. Department Stores National Bank*, No. 08-cv-01596 (S.D.N.Y.).

TILA and Regulation Z’s Requirements

TILA was enacted in 1968 as Title 1 of the Consumer Credit Protection Act. As amended, TILA and Regulation Z provide consumers of credit with certain rights and require certain disclosures of those rights by credit issuers. In the case of credit or charge card accounts, the disclosures that a credit issuer must make are set forth in a model disclosure form entitled Model Form G-3(A), which can be found in appendix G to Regulation Z, 12 C.F.R. § 226. While credit card issuers are not required to use the exact model form, the disclosures must be “substantially similar to the statement found in Model Form G-3(A).” 12 C.F.R. § 226.6(b)(5)(iii).

The Facts

In March 2009, plaintiff Hindy Taub opened a credit account with defendant Big M Inc., a women’s discount clothing store that does business under the name Annie Sez. In connection with that account, Big M provided Taub a document entitled “Annie Sez Retail Installment Credit Agreement,” which con-

tained a “Billing Rights Summary.” The Billing Rights Summary described the rights afforded to Big M consumers who dispute a charge on their credit card.

Plaintiff Taub alleged that the Billing Rights Summary provided by Big M omitted at least part of two sections contained in Model Form G-3(A). The first section, entitled “Your Rights and Our Responsibilities After We Receive Your Written Notice,” informs the consumer that, among other obligations, the credit issuer must acknowledge receipt of a written billing inquiry within 30 days, and must respond to the inquiry within 90 days.

The second section, entitled “Special Rule for Credit Card Purchases,” informs the consumer that he “may have the right not to pay the remaining amount due on the property or services” for a disputed charge. The model form sets forth two limitations on this right: (1) the contested purchase must have been made in the consumer’s home state or within 100 miles of his mailing address, and (2) the purchase price must have been more than \$50.

Defendant Big M’s Motion to Dismiss

In its motion to dismiss, defendant Big M asserted that it should be relieved of liability because its Billing Rights Summary extended greater rights to card holders than those contained in Model Form G-3(A) and, therefore, placed greater burdens on Big M than required by federal law.

Big M responded to the allegation that it had not disclosed the legal time periods for it to respond to a written billing inquiry by asserting that, unlike the model form, its Billing Rights Summary did not require that a billing inquiry be in writing, thereby broadening the rights of consumers. With respect to plaintiff’s allegation that it had omitted the section from the model form entitled “Special Rule for Credit Card Purchases,” Big M pointed to corresponding language in its Billing Rights Summary that had the same title and very similar language. The difference was that Big M’s disclosure excluded the limitations contained in the model form, that is, that the purchase must have been made (1) within 100 miles of, or in the same state as, the consumer’s mailing address, and (2) have a price of more than \$50. Big M argued that, because it did not include these limitations in the Billing Rights Summary, the rights it granted its card holders were in fact broader than those granted by Model Form G-3(A).

The Court’s Opinion

The court rejected Big M’s arguments on both factual and legal grounds. As a factual matter, it / *continued page 24*

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found no evidence that the defendant had actually extended to its card holders more generous terms than those set forth in the model form. The court noted that the form of installment credit agreement that Big M submitted with its motion was silent on the subject of billing errors and disputes, other than the challenged disclosures contained at the bottom. The court implicitly rejected Big M's argument that the absence in the Billing Rights Summary of certain express limitations on the rights of its card holders was evidence that those limitations were not applied in practice.

More importantly, the court rejected as a matter of law any link between the terms of a credit agreement and the disclosures required by TILA, reasoning that the terms of the credit agreement were irrelevant to rights available under the law. "The disclosures mandated by [TILA and Regulation Z] pertain to a consumer's rights and obligations under TILA, and are thus necessary regardless of the consumer's rights and obligations under her agreement with the creditor ... [they] are independent of any additional rights the consumer may have pursuant to her agreement with the creditor."

Conclusion

Taub's strict interpretation of the requirement that consumer credit disclosures be "substantially similar" to those in Model G-3(A) sounds a cautionary note to credit issuers. Regardless of the actual terms of the credit agreement, disclosures that vary substantially from the model form render credit issuers vulnerable to class action suits. Perhaps it is time to revisit that disclosure statement. ©

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