

DEALING WITH THE DESPERATE DEBTOR

Lunch & Learn

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A Difficult Climate

- Delinquent debtors hold substantial leverage with courts
- Creditors get even less of a benefit of the doubt than before the 2008 economic downturn
- Creditors are hamstrung in pursuing even secured debts
- Dotting "i"s and crossing "t"s never more imperative

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The Creditor's Potential Problems Start with Marketing

- ❑ Financial institutions typically sell the relationship based on trust —
 - A loan or line of credit is not the only thing discussed
 - Private Banking / Relationship Management is offered
 - Guidance and companionship are a key part of the inducement
- ❑ The online materials published by financial institutions for consumers and small businesses may make the relationship sound more like a marriage than a loan transaction

The Creditor's Shortcomings and Efforts Undertaken to Collect the Debt may be Magnified in Collections Litigation

- ❑ Upon default, the business relationship falls apart
- ❑ But, instead of acknowledging a debtor-creditor relationship, the debtor now thinks he or she is in a de facto marriage with the financial institution
- ❑ As a result, debt collection efforts begin to take on the characteristics of divorce litigation; instead of simply addressing debt issues, the financial institution may ultimately have to dedicate its efforts to fighting off vitriolic attacks from the debtor

Q: Will courts allow the desperate debtor to place the emphasis on the creditor's efforts instead of the debtor's fundamental failure to make payment?

A: Absolutely (At least in Kansas and probably in Missouri)

What Liability Theories will a Kansas District Court Allow a Debtor to Pursue Against its Creditor?

- In addition to the usual alphabet soup (FDCPA, RESPA, etc.), a Kansas court recently allowed a commercial debtor to pursue — and prevail on — the following liability theories against its lender (a financial institution)
 - Breach of fiduciary duty;
 - Breach of the implied covenant of good faith and fair dealing that exists in every contract; and
 - Fraudulent and negligent misrepresentation

Breach of Fiduciary Duty — A Thorny Legal Problem

- Historically, the relationship between a financial institution and its customer is “ordinarily that of creditor-debtor and not of a fiduciary nature;” as a result, courts have been reluctant to find the existence of a fiduciary duty between a financial institution and its debtor
- BUT, a court may determine a fiduciary relationship exists when the financial institution “dealt directly with the customer regarding the matters involved in the litigation, and the [financial institution] had knowledge of the reliance and confidence of the customer, in some instances the [financial institution] stood to profit from non-disclosure to the customer”

Breach of Implied Covenant of Good Faith and Fair Dealing

- Every contract — other than an employment-at-will contract — contains an implied obligation of good faith and fair dealing
- A party will be liable for breaching the implied covenant of good faith and fair dealing when the party intentionally and purposefully does something to prevent the other party from carrying out his or her part of the agreement or if the party does anything that will destroy or injure the right of the other party to receive the fruits of the contract

A Johnson County District Court Judge Finds a Financial Institution Liable for Breach of Fiduciary Duty

Some of the Pertinent Facts

- Financial institution and customers — a couple who owned a company — had an eight-year business relationship
- Financial institution had private bankers who worked with the customers; financial institution marketed itself to customers as their trusted financial advisor
- Customers viewed their private bankers with high regard and trust
- Customers' business was expanding and one of the private bankers encouraged them to build a brand new building

Some of the Pertinent Facts

- Financial institution sold the customers a particular loan product — a swap interest rate protection product
- Customers contended they did not know much about the product other than that financial institution advised them it would ultimately result in a fixed rate of interest

More Pertinent Facts

- ❑ 9/11 happens as building is being constructed
- ❑ Customers' business looks like it may have bumps in the road in the future but customers continue to make payments while construction continues
- ❑ Financial institution refers matter to special assets department for management, handling and potential restructure
- ❑ Internally, financial institution determines it needs to get out of business relationship with the customers

More Pertinent Facts

- ❑ Financial institution does not tell the customers it is pursuing an exit strategy and does not respond to customers' request for information as to why the matter has been referred to special assets
- ❑ Financial institution's counsel drafts a modification to loan agreement removing financial institution's obligation to make permanent loan following completion of building
- ❑ Financial institution does not tip off the customers that obligation to make permanent loan has been removed from modification to loan agreement, but institution places short-time fuse on customers to sign

A Johnson County District Court Judge Finds a Financial Institution Liable for Breach of Fiduciary Duty

- ❑ Results
 - Financial institution was found liable for breaching its fiduciary duty
 - Financial institution was found liable for breaching implied covenant of good faith and fair dealing
 - Financial institution was found liable for fraudulent misrepresentation
 - AND, THE FINANCIAL INSTITUTION WAS FOUND LIABLE FOR PUNITIVE DAMAGES

Let's Quickly Look Back at the Underlying Ramifications

- ❑ Case started as a lawsuit filed by financial institution alleging breach of promissory note, mortgage and interest rate swap agreement
- ❑ Case turned into scathing indictment of financial institution's business practices
- ❑ Court hammered financial institution for its marketing as a trusted advisor
- ❑ Court allowed small business owners who had been in business for many years to be helpless victims subjected to the sophisticated financial institution's plots and schemes

Practical Results

- ❑ Copycat counterclaims in KS; every financial institution will be forced to defend its business decisions
- ❑ Discovery into internal communications when matters are referred to internal departments for risk evaluation and assessment
- ❑ Logical exit strategies based on reasoned analysis of declining business or market downturn — 9/11, 2008 financial issues — will be transformed to nefarious plots
- ❑ Financial institution marketing and "buddy" efforts will boomerang

How can the financial institution avoid these potential pitfalls?

Change marketing strategies

Failing that . . .

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10 Practical Solutions for Dealing with the Desperate Debtor

1. Read loan instruments before proceeding with collection efforts and follow loan instruments' instructions in crafting any demand letter
2. Work with debtor to exhaust solutions before proceeding with litigation
3. When debtor is only at risk of default, advise debtor of change in loan status and advise debtor of necessity of evaluating exit strategy based on risk

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10 Practical Solutions for Dealing with the Desperate Debtor

4. Give debtor ample time to read and review proposed modifications or work-out agreements before requiring a signature
5. Always advise debtor to consult with his / her / its own attorney before signing a loan modification / forbearance agreement; you are not your debtor's keeper
6. Take every opportunity to advise debtor in writing that you do not have a fiduciary relationship and that you are simply in a debtor-creditor relationship

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**10 Practical Solutions for
Dealing with the Desperate Debtor**

- 7. Continue to honor your agreements until there is an actual default; always assume courts will give you no benefit of the doubt and that you hold all the bargaining power
- 8. Approach every case as if you will be found to owe a fiduciary duty
- 9. Take your foot off the jugular; satisfy your loans and get necessary payments but think long and hard before allowing talks to break down over claims for extra fees, penalties and default interest rates

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and, finally . . .

- 10. Never pursue a secret strategy and never bad mouth debtor in any internal or external communications
 - Tell debtor about each and every one of your concerns, but be correct in your written assessment — or else risk a defamation lawsuit brought by desperate debtor — another topic for another lunch
 - Assume everything you write to anyone will make its way into court

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A Brief Segue into Consumer Debt Developments

- Last week, the U.S. Supreme Court found a law firm liable for advising a consumer in a Fair Debt Collection Practices Act demand letter that consumer needed to contest debt in writing
- LESSON — Re-read your demand letters to make sure you are maintaining compliance with Fair Debt Collection Practices Act
- A copy of the opinion is enclosed with your materials

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The Equal Credit Opportunity Act

Protecting Yourself from Modern-Day Bonnies



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Bonnie Parker



10
Texas
meets up with Clyde
34
series
commits 15 murders, including
officers

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Bonnie Parker

- Never killed anyone
- Accomplice to more than 100 criminal actions
- Although disputed, the weight of evidence is that she never shot a gun
- Gang member W.D. Jones — "During the five big gun battles I was with them, she never fired a gun. But I'll say she was a hell of a loader"



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The "Bonnies" of the ECOA

- ❑ As was the case in the 1930s, financial institutions have gotten their money taken from them
- ❑ While the "applicant" may have fired the gun, the applicant's spouse might be a "hell of a loader"
- ❑ By learning how to deal with spousal defenses under the ECOA, you can better deal with the modern-day Bonnies

History of the ECOA

- ❑ Passed by Congress in 1974 and amended in 1976
 - 1974 bill only covered gender
 - 1976 amendment expanded coverage to race / national origin
- ❑ Language — It is "unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction . . . on the basis of sex or marital status"
- ❑ Original purpose — allow a married woman to apply for credit without having to include her husband as a co-applicant

Evolution of the ECOA

- ❑ Examples of married women claiming discrimination in an institution's failure to approve a loan or requiring of spousal participation represent a small percentage of the cases
- ❑ Challenges based upon other kinds of discrimination (*e.g.*, race, age) are also relatively small in number
- ❑ Chief use is as a weapon by married couples to block full enforcement of loan obligations

Common Characteristics of Defendants Using the ECOA

- Loan applicant is a small business
- Owner of business personally guarantees the loan
- Owner's personal financial statement contains numerous assets jointly owned with a spouse
- Spouse signs personal guaranty to allow bank to collect against all assets supporting the loan application

Methods of Raising the ECOA

- Separate lawsuit to challenge the enforceability of the loan
- Financial institution sues borrowers; borrowers counterclaim under the ECOA
- Financial institution sues borrowers; borrowers assert an affirmative defense that the ECOA precludes enforcement of loan or guaranty

Overview of the ECOA

- Prohibits discrimination against an "applicant" on the basis of sex, race, and marital status
- Provides for civil liability for violations
 - Damages arising from violation
 - Punitive damages (not greater than \$10,000 for individual claims or \$500,000 for class actions)
 - Equitable relief (*i.e.*, the ability of a court to prevent enforcement of debtor's contractual obligation)
 - Attorneys' fees
- The Federal Reserve Board is permitted to promulgate regulations

Overview of Federal Reserve Board Regulations

- ❑ Federal Reserve Board's regulations under the ECOA are known as "Regulation B"
- ❑ Purpose — define what constitutes discrimination under the ECOA

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Two Threshold Issues

- ❑ What is an "applicant" for credit?
- ❑ How much authority do courts have to prevent a financial institution from enforcing guarantys signed by borrowers?

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What is an "Applicant"?

- ❑ ECOA — It is "unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction . . . on the basis of . . . marital status"
- ❑ ECOA — An applicant is a person who "applies to a creditor directly for an extension, renewal, or continuation of credit . . ."
- ❑ Reg. B — An applicant includes anyone who "may become contractually liable for an extension," which includes "guarantors"

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Conflict Between Definition of "Applicant" in ECOA and Reg B

- ❑ ECOA definition is consistent with general understand that an "applicant" must actually apply for something
- ❑ Reg B definition extends "applicant" to someone — a guarantor — who actually assists the "applicant"
- ❑ Two courts have taken issue with Reg B on this basis
 - Moran Foods (Judge Posner, 7th Circuit; 2007)
 - Champion Bank (Eastern Dist. of MO; May 2009)
- ❑ If this theory is accepted by the Supreme Court, it could gut the most common use of the ECOA

Can Courts Actually Block Enforcement of a Guaranty?

- ❑ ECOA allows a court to "grant such equitable or declaratory relief as is necessary to enforce the requirements" of the ECOA
- ❑ Some courts hold that a guaranty cannot be voided even if the ECOA is violated
- ❑ Other courts hold that a guaranty can be voided
- ❑ Split exists even within Kansas district courts
- ❑ Slight split in Missouri state court
- ❑ Until this issue is clarified, financial institutions must assume the worst — that a violation precludes enforcement of a loan instrument

General Standards in the Reg B

- ❑ Basic rule — "A creditor shall not require the signature of an applicant's spouse or other person, other than a joint applicant, on any credit instrument, if the applicant
 - qualifies
 - under the creditor's standards of creditworthiness for the amount and terms of the credit requested" (d)(1)
- ❑ If the applicant does not qualify, it is OK to look to a guarantor, but bank cannot mandate that the guarantor be a spouse (d)(5)

Meaning of "Creditor's Standards of Creditworthiness"

- Financial institutions have almost no restrictions in crafting their own standards for creditworthiness
 - A "creditor is permitted to apply its own criteria for determining creditworthiness so long as it is based on criteria which are —
 - Valid;
 - Reasonable; and
 - Non-discriminating with regard to the applicant's marital status"

Examples of Approved "Standards of Creditworthiness"

- Need not be a mathematical formula
- General multi-factor tests, so long as applied evenhandedly, are acceptable
- Kansas case — requiring "\$2 million in liquidity" satisfied requirements
- Ramsdell (1st Cir. 1995) — finding that applicant failed to meet standards of creditworthiness because of prior defaults
- Best approach would be to create a checklist of any relevant consideration and permit loan officers to draw from that checklist in evaluating applications

Application of Regulation B to Spousal Guarantys

- Timing is everything
- Official comment to Regulation B
 - "When an applicant requires individual credit, a creditor generally *may not* require the signature of *another person* unless the creditor has *first determined* that the applicant alone does not *qualify* for the credit requested"

Application of Regulation B to Spousal Guarantys

- ❑ If applicant for loan approval relies upon jointly-owned assets, the creditor can require the signature of the co-owner if it is —
 - “reasonably believed” to be necessary to reach that property under the law of the state where the property is located (d)(2)
 - Official comment — creditor must value the applicant’s interest in the jointly-owned property
 - Look to (1) form of ownership; (2) susceptibility to attachment, execution, severance or partition
 - After deducting for the costs associated with gaining access to the property in question, calculate the applicant’s interest
- ❑ PFS should contain column for asset ownership

Analyzing Property Situated in Missouri and Kansas

- ❑ Missouri — Tenancy by the Entireties
 - Rebuttable presumption that each spouse owns the “entirety” of the real and personal property held jointly
 - Effect? Very difficult for creditors to reach jointly-owned property when judgment is only against one spouse

Analyzing Property Situated in Missouri and Kansas

- ❑ Kansas—Joint Tenancy
 - Rebuttable resumption that property that each spouse owns 50% of jointly-held property
 - Allows creditor to reach up to 50% of the value of jointly-owned property
- ❑ If applicant holds assets in different states, loan officer must separately analyze each piece of property under the appropriate state law
- ❑ PFS should contain column for asset location

Distilling Reg B's Requirements

- ❑ Require applicant to prepare a personal financial statement
- ❑ Individually analyze the applicant's creditworthiness under financial institution's standards for creditworthiness
- ❑ Only ask for guaranty after determining that applicant is not individually creditworthy

Application of ECOA and Reg B to Kansas Case

Timeline

- ❑ 3/2 — Small business applies for \$3.8 million loan
- ❑ 3/2 — Bank's "term sheet" states that a personal guaranty from both husband and wife is required
- ❑ 3/5 — Loan officer prepares credit analysis that only references owner-husband as guarantor, shows \$2.3 million in "liquid assets," and makes no mention of wife or any joint assets
- ❑ 3/18 — Loan commitment approved, with notation that \$2 million in liquidity is required
 - Commitment letter requires personal guarantys from both *husband* and *wife*
- ❑ 3/24 — Husband prepares personal financial statement showing net worth of \$5.5 million
 - Except for \$885,000 in securities, no identification of whether the assets were individual or joint
- ❑ 4/1 — Loan documents signed, including personal guarantys from husband and wife

Application of ECOA and Reg B to Kansas Case

- ❑ Two years later — small business defaults on loan
- ❑ Husband files for bankruptcy
- ❑ "Bonnie" — the wife — sues under the ECOA in order to protect a portion of the couple's assets

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Kansas Example of Analyzing Creditworthiness Under the ECOA

- ❑ Bank argued, in support of a legal determination prior to trial, that —
 - PFS disclosed "joint assets," so
 - Bank "reasonably believed" that it needed guarantys from both parties, and the wife signed the guarantys after submission of the PFS

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Kansas Example of Analyzing Creditworthiness Under the ECOA

- ❑ Court rejected Bank's argument because —
 - PFS did not ask the applicant to specify whether particular assets were owned by husband, wife, or jointly;
 - Prior to requiring the spousal guaranty, defendant did not otherwise ask about asset ownership
 - No evidence that Bank even reviewed the PFS prior to wife's execution of the guaranty
 - Even if Bank actually reviewed the PFS, no evidence that Bank separately valued applicant's interest in jointly-owned property

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Kansas Example of Analyzing Creditworthiness Under the ECOA

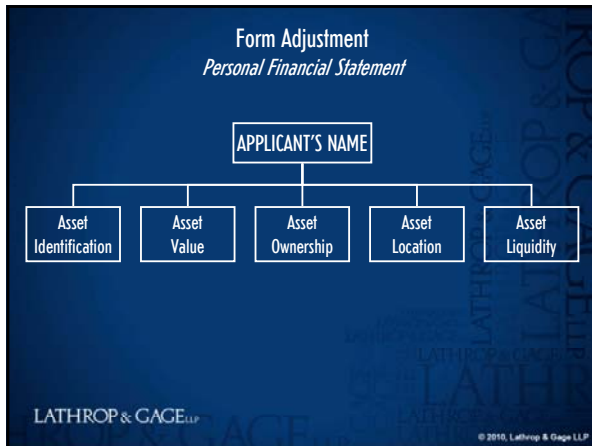
- ❑ Court also found that Bank failed to offer applicant an alternative to a spousal guaranty
- ❑ Two controlling pieces of evidence
 - Applicant's testimony that defendant never discussed the possibility of another guarantor
 - Loan commitment required spousal guaranty before applicant ever provided any documentation of jointly-owned assets

Missouri Case and Equitable Factors

- ❑ Facts
 - 1992 — Bank makes loan to husband who is part of limited partnership
 - Husband and wife each sign guarantys encompassing any present or future debt
 - 1995 — Bank makes second loan to husband, without any guaranty by wife
 - 1997 — Husband defaults on 1995 loan and declares bankruptcy
 - 1997 — Bank sues wife for 1992 guaranty; wife raises an affirmative defense under the ECOA
- ❑ MO Supreme Court denies summary judgment on ECOA and asks trial court to examine —
 - Was the wife in business with her husband?
 - Did wife otherwise benefit from the loan covered by her guaranty?

Lessons Learned from ECOA Cases

- | | | |
|--|-------------------------------|---|
| <ul style="list-style-type: none">❑ Mistake<ul style="list-style-type: none">• Forms lacked information key to ECOA analysis• Narrow standard for creditworthiness omits factors relevant to rationale for requiring guaranty• Financial institution commingled analysis of applicant with that of the guarantor | <p>←→</p> <p>←→</p> <p>←→</p> | <ul style="list-style-type: none">❑ Correction<ul style="list-style-type: none">• Adjust forms to facilitate compliance with ECOA• Specifically reference all relevant factors in standard for creditworthiness• Ensure that applicant's creditworthiness is evaluated before that of the guarantor, not at the same time |
|--|-------------------------------|---|



- ### Form Adjustment — Loan Application
- Make sure that applicant(s) are specifically and clearly identified as applicants
 - Ensures that applicants are evaluated separately from guarantors
 - ECOA treats “applicants” differently from guarantors
 - Advise applicant that a failure to individually qualify “may” necessitate a guaranty by a third party
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- ### Form Adjustment — Loan Analysis
- Subdivide analysis section to ensure separate evaluation of applicant and guarantor
 - Make sure that the “applicant” section explains why applicant is not separately creditworthy
 - If the applicant is not separately creditworthy, “guarantor” analysis should identify how the addition of guarantor tips the scales toward loan approval
 - Ideally, this section will be dated to show that this analysis took place at later date
 - Either a checkbox or notation near this section should reference having discussed the idea of a guaranty with the applicant
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Form Adjustment — Loan Analysis

□ For credit standards, identify factors other than asset value and adjust document to facilitate loan officers' ability to reference these factors in separately evaluating the applicant

- Prior defaults
- History of delayed payment
- Goal — Expand the number of factors that can be used to defend, at a later date, the decision to secure a spousal guaranty
- Analogous to termination in employment law

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Order of Events

1. Secure full and complete Personal Financial Statement as part of loan application
2. Separately analyze creditworthiness of applicant
3. If applicant lacks creditworthiness, inquire into possibility of a guaranty
4. Analyze creditworthiness with guaranty
5. Secure signatures on guaranty

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Results of Good ECOA Compliance!



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