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Welcome to another issue of the *Commercial Lending Bulletin*, a newsletter published monthly by the Commercial Lending Group at Lerch, Early & Brewer as a service to our clients. Here, you will find articles written by our attorneys covering a variety of current legal issues as they affect lending law. We publish the *Bulletin* as part of our ongoing efforts to provide our clients with responsive service and practical advice when needed.

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Seminar Alert!

Look out for a new seminar to be scheduled in June relating to changes in the SBA's SOP 5010.

Lender Not Required to Foreclose on Real Property When Life Insurance Proceeds Are Used to Satisfy Debt

A DISTRICT COURT IN KENTUCKY RECENTLY HELD THAT A LENDER COULD SATISFY ITS DEBT FROM LIFE INSURANCE POLICY PROCEEDS DESPITE THE FACT THAT THE LENDER ALSO HELD A MORTGAGE ON THE DECEASED'S PROPERTY.

In 1983, George Mattingly acquired a base life insurance policy for \$30,000. Included in the policy was a 15-year "step rated term to age 85 spouse rider" worth \$20,000. In 1988, Mattingly obtained an \$89,700 loan from the U.S. Small Business Administration. His loan was secured by a mortgage on certain real property and an assignment of his life insurance policy to the SBA. The assignment stated that Mr. Mattingly agreed to "assign the policy and any supplemental contracts issued in connection



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therewith upon the life of George R. Mattingly to the SBA and its successors. Beal Bank became the successor in interest to the SBA. In 1990, Mattingly modified his insurance policy without Beal Bank's knowledge, replacing the initial \$20,000 spouse rider with a "15-year step prem term rider to age 85" worth \$70,000. In 2005 George Mattingly died. After his death, the insurance company learned of Beal Bank's claim and refused to pay Cathy Mattingly the proceeds. Cathy Mattingly filed suit against the insurance company demanding full payment of the insurance proceeds and the insurance company filed a third party complaint against Beal Bank.

First, Ms. Mattingly argued that Beal Bank had an obligation to enforce the mortgage on the real property before seeking to collect under the assigned life insurance policy. Ms. Mattingly argued that under Kentucky case law, when the debt of an insured is secured by both a mortgage and an assignment of life insurance, the intention of the insured is the controlling factor in determining the rights of the parties. Ms. Mattingly argued that because there was no indication in the assignment that George Mattingly intended to place the assignment before the mortgage, Beal Bank had to first collect against the real property. Second, Ms. Mattingly also contended that because separate premiums were paid for the base policy and the spousal rider, they were actually separate policies. Finally, Ms. Mattingly argued that Beal Bank did not offer any additional consideration to her husband when he modified the rider from \$20,000 to \$70,000 and Beal Bank collecting the additional sum would be unjust enrichment.



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The District Court disagreed with these arguments. With regards to her first argument, the Court noted that the assignment expressly stated that the assignee could determine the order in which it chose to deal with its security for the loan. With no evidence of contrary intent, Beal Bank could request payment of the insurance proceeds first. Ms. Mattingly's argument for separate policies was also not persuasive. The Court found that since George Mattingly agreed to assign the policy and "any supplemental contracts issued in connection therewith..." upon his life, Beal Bank was within its rights to attach the spousal rider, as well as the base policy, since even if the riders were separate policies, they were clearly supplemental contracts contemplated by the assignment. Finally, the Court looked at the unjust enrichment claim. Beal Bank made no change to its contract with George Mattingly and he unilaterally increased the rider coverage without Beal Bank's knowledge. The Court found that unjust enrichment does not apply when an explicit contract has been performed and unanticipated problems arise, as long as both parties are in an equal position as to knowledge and information regarding the contract. Since this was a unilateral change by George Mattingly, Beal Bank was entitled to the benefits of that decision, even if it may have been a mistake on Mr. Mattingly's part.

Assignments of life insurance policies are common additional collateral required by U.S. Small Business Administration and other lenders. Assignments of the life insurance policies are often drafted by the insurance companies themselves, so lenders should review the documents to ensure that the assignment includes any supplemental contracts and does not require the lender to pursue other sources of collateral first. If the assignment is not clear, the lender should negotiate with the insurance company to include both of these important provisions in an assignment.

The case above is cited as *Mattingly v. Primerica Life Ins. Co., et al.*, No. 06-479-C (W.D. Ky. 09/20/07)



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Assignee Can Enforce Note Despite its Loss by Assignor

THE SUPREME COURT OF ALABAMA HAS DETERMINED THAT AN ASSIGNEE OF A LOST PROMISSORY NOTE WHO WAS NOT RESPONSIBLE FOR THE LOSS OF A PROMISSORY NOTE IS ABLE TO ENFORCE THE NOTE REGARDLESS OF THE LOSS.

In *Atlantic National Trust, LLC v. Jack McNamee*, SouthTrust Bank (now Wachovia) made a \$150,000 loan to McNamee. Wachovia misplaced, lost or destroyed the original note. The loan matured on August 5, 2005 but was not paid. Wachovia assigned the note to Atlantic as of December 21, 2005. McNamee also failed to pay Atlantic and as of March 1, 2006 the principal balance outstanding was \$138,620 plus interest. Atlantic filed suit for repayment.

In litigation to enforce the note, Atlantic submitted a lost note affidavit signed by a representative of Wachovia which stated that the original note had been misplaced, lost or destroyed and could not be found after diligent search and inquiry. The affidavit provided a true, correct and complete copy of the note and assigned the note to Atlantic. McNamee claimed that, since Wachovia had lost the original note, it was unable to enforce the note at the time it assigned the note to Atlantic, therefore, Atlantic was also unable to enforce the note. McNamee also claimed that Alabama law only allowed the entity in possession of the note at the time of its loss to enforce it.

The Supreme Court of Alabama disagreed with McNamee and found that the Uniform Commercial Code in effect in Alabama does not prohibit the "post-loss assignment of the right to enforce a lost, destroyed, or stolen promissory note." The Court stated that, although the UCC does not specifically allow the assignment of the right to enforce a lost note, the UCC does not prohibit it, either. Rather,



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the Court allowed itself to be governed by a different provision of the UCC which provides that unless the UCC specifically addresses an issue, the UCC can be supplemented by principles of law and equity. Alabama law provides that an assignment conveys the assignee all of the rights of the assignor. Accordingly, the Court determined that Atlantic is able to enforce the note to the same extent as Wachovia.

The case above is cited as *Atlantic National Trust, LLC v. Jack McNamee*, 2007 WL 2898263 (Ala.).

Depository Banks Must Ensure Employee Has Responsibility Before Cashing Company Checks

A TEXAS DISTRICT COURT FOUND THAT AN EMPLOYEE WHO CASHED COMPANY CHECKS FOR HIS OWN BENEFIT WAS NOT AN "EMPLOYEE WITH RESPONSIBILITY" AS DEFINED BY THE UNIFORM COMMERCIAL CODE AND THAT THE CHECK CASHING FACILITY WAS LIABLE IN THE MATTER FOR FAILURE TO EXERCISE ORDINARY CARE.

William Rittenberry was employed by A/W Mechanical Services, L.P. Among his duties was picking up checks from A/W's clients and delivering them to A/W's office. During 2004, Rittenberry fraudulently endorsed nine checks totaling \$38,130.59 and cashed the checks at a gasoline station owned by Shekhani Enterprises, Inc. The checks were all made payable to A/W, although Rittenberry presented them to be cashed by signing his own name on the back of each check. A/W fired Rittenberry and filed criminal charges. Rittenberry pleaded guilty to theft and A/W then sued Shekhani on claims of conversion. The trial court found in favor of A/W and ordered Shekhani to pay the \$38,130.58, plus attorney's fees. Shekhani appealed.

On appeal, Shekhani argued that Rittenberry was an A/W employee with "responsibility" regarding checks made payable to A/W, as the term "responsibility" is defined by the UCC and thus A/W was responsible for the loss resulting from Rittenberry's actions. A/W argued that even if Rittenberry had responsibility regarding the company's checks, the loss was still the result of Shekhani's failure to exercise ordinary care by paying the checks in question without verifying that Rittenberry was authorized to cash them on behalf of A/W and Shekhani's failure substantially contributed to the loss caused by Rittenberry's fraud.

Under the UCC, in general, a depository bank is liable for taking a check for deposit over the payee's forged endorsement. However, the depository bank has no liability when an employee embezzles funds by fraudulently endorsing checks either payable to or drawn by the employer. An employer is only liable for an employee's fraudulent endorsement if the employee was authorized to perform any of the following responsibilities:

- sign or endorse instruments on behalf of the employer;
- process checks received by employer for bookkeeping purposes;
- prepare or process checks drawn by the employer;
- supply information determining the names or addresses of payees of checks drawn by the employer; or
- control the disposition of checks to be drawn by the employer.

In this case, the Court found that Shekhani was negligent since it acted with conscious indifference by failing to verify Rittenberry's authority to cash checks made payable to A/W and, therefore, was responsible for the loss in this case.

Institutions should be wary of cashing checks that appear to be altered or forged in some way. Any institution which pays on a forged check may incur substantial losses if it does not perform the necessary due diligence to ensure that the person presenting the check has the actual authority to do so.

The case above is cited as *Shekhani Services, Inc. v. A/W Mechanical Services, L.P.*, No. CV-01-06-00629-CV (Tex. App. 11/15/07)

Ambiguously Defined Terms in Loan Agreement Not Enough to Support Breach of Contract Claim

A NEW YORK COURT HELD THAT A BROKERAGE FIRM HAD NOT BREACHED ITS CONTRACT WITH THE CREDITOR WHEN THE BROKERAGE FIRM SOLD A LOAN TO A THIRD PARTY, WHO THE CREDITOR CLAIMED WAS A COMPETITOR.

In June 2001, Bear Stearns Fundings, Inc. entered into a loan agreement with Interface Group-

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Nevada Inc. in which Bear Stearns loaned Interface \$141 million. This loan was secured by a mortgage encumbering the Sands Expo and Convention Center in Las Vegas. Bear Stearns' policy was to treat the loans as commodities and transfer its interest in those loans to third parties or into capital markets. The loan agreement allowed Bear Stearns "to sell, issue participations in, or securitize all or part of the loan." Additionally, Section 9.1 of the loan agreement defined securitization as "one or more private or public securitizations... securitized by or evidencing ownership interests in all or any portion of the Loan and the Loan Documents or a pool of assets that included the loan." The loan agreement further stated in Section 10.24 that Bear Stearns would not assign the loan to a competitor of Interface and competitor was defined as "a person who at the time of disposition then (i) owns or operates (or is an Affiliate of a Person that owns or operates) a casino that is located in the State of Nevada or the State of New Jersey, (ii) owns or operates (or is Affiliate of a Person that owns or operates) a Competing Facility." Finally, a side agreement to the loan established that Interface would promptly pay the disposition costs, defined as the "costs of Securitization" incurred by Bear Stearns when it sold the loan.

Bear sold the loan to Starwood Capital and Interface refused to pay the costs of the disposition, contending that Starwood was a competitor. Bear Stearns filed suit against Interface for breaching the loan agreement by failing to pay the costs of the disposition. Interface counterclaimed against Bear Stearns for many claims, among them a breach of contract claim relating to the competitor restriction in the loan agreement.

The Court found that the term "securitization" was not defined in Section 10.24, which was the competitor restriction provision, although it was defined in Section 9.1 of the loan agreement. The Court found that the definition of securitization was so broadly defined it could apply to any sale, participation or securitization of all or part of the loan. The Court reasoned that applying the definition in Section 9.1 would render Section 10.24 meaningless. The Court determined that the parol evidence rule, which presumes that a written contract embodies the complete agreement between the parties involved and the document is the sole repository of the terms of the contract, would have to be applied to determine the meaning of securitization.

Bear Stearns argued that even if the transaction was not a securitization, the breach of contract claim would fail because Starwood was not a competitor of Interface. The Court examined all of the affiliations between Starwood and other casinos and determined Starwood did not own or control a casino at the time of the transaction, although there was evidence that it did shortly thereafter. Therefore, the Court was able to determine that Bear Stearns' sale of the loan to Starwood did not violate the competitor provision and was not a breach of contract under the loan agreement.

Lenders should carefully examine all loan documents to ensure that defined terms meet two important criteria: (1) that they are specific enough to establish not only the business terms agreed upon but also a meaning that a court can determine, and (2) that they are broad enough to anticipate issues and situations that may arise after the loan has closed. More carefully defined terms in the above-case would have helped the lender avoid or minimize this dispute. It is also important to be sure that definitions and other terms do not conflict and render them meaningless.

The case above is cited as *Bear Stearns Funding, Inc. v. Interface Group-Nevada, Inc.*, No. 03-Civ. 8259 (S.D.N.Y. 07/10/07)

Seminar Alert!

Look out for a new seminar to be scheduled in June relating to changes in the SBA's SOP 5010!

Arnold Spevack and Alison Rind will highlight revisions to the SOP's 5010 and discuss hot topics and points of contention raised at NAGGL's Mid-Year Conference recently held in Jacksonville, Florida. The seminar will be scheduled upon issuance by the SBA of the revised SOP (further revisions to be completed prior to its effective date) and will be held prior to the effective date of implementation of the new SOP.

Be sure to check your email inbox for the official invitation to the event, which will be held in the offices of Lerch, Early & Brewer. You may also contact Bill Melchior at wgmelchior@lerchearly.com for more details.

We Would Like To Hear From You

We publish this newsletter as a service to our clients as a means to make them aware of certain aspects of the law. As always, we would like to hear feedback from our readers regarding the content of the newsletter. If there are items or topics you would like to see covered in future issues, or you have a suggestion concerning the newsletter itself, you may send them to Paddy Shakin at ptshakin@lerchearly.com.

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