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SUPREME COURT REFUSES TO APPLY BANKRUPTCY CODE'S STAMP TAX EXEMPTION TO PRE-CONFIRMATION TRANSFERS

Anything that diminishes a bankruptcy estate harms creditors by decreasing the funds available to pay them. Stamp taxes, payable to the state on the transfer of assets, can divert significant funds from creditors to the state. To protect creditors' interest, § 1146(a) of the Bankruptcy Code exempts transfers "under a plan confirmed under Section 1129" from stamp taxes or other similar taxes. If this provision applies, a debtor's bankruptcy estate need not pay a state stamp tax on asset transfers, thereby leaving more for the creditors. In a recent decision, however, the United States Supreme Court has narrowly construed this exemption to apply only to those transfers that occur after a Chapter 11 plan has been confirmed by a bankruptcy court.

On October 29, 2003, Piccadilly Cafeterias filed a Chapter 11 bankruptcy petition. As part of its filing, Piccadilly asked for court approval to sell substantially all of its assets pursuant to § 363(b) of the Bankruptcy Code. Piccadilly planned to sell its assets as a "going concern" and sought an exemption from any state-imposed stamp taxes pursuant to § 1146(a). On January 26, 2004, as a precondition to the sale, Piccadilly entered into a settlement agreement with its creditors, dictating the distribution of the sale proceeds to its creditors. The bankruptcy court approved the sale and settlement agreement on February 13, 2004, and ruled that the transfer of assets would be exempt from Florida's stamp tax. The bankruptcy court then conducted an auction, at which the winning bidder agreed to pay $80 million for Piccadilly's assets; the sale closed on March 16.

The State Objects

Piccadilly filed its initial Chapter 11 reorganization plan with the bankruptcy court on March 26, 2004, after the sale of its assets. Piccadilly filed an amended plan on July 31. The plan provided for the distribution of assets in a manner consistent with the settlement agreement. Before the court confirmed the plan, however, the Florida Department of Revenue filed an objection, arguing that the § 1146(a) exemption did not apply to the $39,200 due in Florida stamp taxes because the sale of Piccadilly's assets was not "under a plan confirmed" under Chapter 11.

The bankruptcy court rejected Florida's claim, instead holding that because the asset sale was necessary to consummate the Chapter 11 plan, the sale was a transfer "under" Piccadilly's confirmed plan. A district court affirmed the bankruptcy court's decision, as did the United States Court of Appeals for the Eleventh Circuit. The circuit court held that § 1146(a) was satisfied as long as there is "some nexus between the pre-confirmation

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transfer and the confirmed plan." The Supreme Court granted review, however, and reversed.

Interpreting the Statute

On appeal, Piccadilly argued that the Eleventh Circuit's "liberal" interpretation of § 1146(a) squared with the "remedial nature" of the Bankruptcy Code. Florida countered that the clear language of the provision indicates that § 1146(a) applies only to post-confirmation sales of assets. While the Court found merit in both arguments, the Court ultimately held that Florida's interpretation was more consistent with the purpose and context of § 1146(a). Here, the sale of Piccadilly's assets occurred before Piccadilly submitted its Chapter 11 plan for confirmation. Thus, the Court stated that an "asset transfer can hardly be said to have been consummated in accordance with" a confirmed plan, when the sale occurs before the debtor has even submitted a plan for confirmation.

Moreover, the Court took issue with the Eleventh Circuit's statement that the provision should be "liberally construed." Instead, because the provision involves issues of federalism, the Court held that the exemption should be narrowly construed. The Court noted that Congress had created a narrow exemption for state taxes and refused to broaden its reach.

Finally, the Court noted that the bright-line rule advanced by Florida would be simpler to administrate than the "nexus" test advanced by Piccadilly and adopted by the Eleventh Circuit. Thus, the Court held that § 1146(a) exempts stamp taxes only for transfers that are made pursuant to a confirmed Chapter 11 plan. (*Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*, 2008 WL 2404077 (U.S. June 16, 2008).)

OBSERVATION: Justices Breyer and Stevens dissented. The dissenters believed that imposing a "temporal limitation" as the majority had done did not advance Congress's intent in enacting the provision. The dissenters pointed out that the purpose of § 1146(a) is to preserve going concerns and maximize the property available to creditors. According to the dissent, the majority's interpretation of § 1146(a) failed to advance those goals.

TWO DAY ERROR IN RIGHT TO RESCIND DISCLOSURE GIVES BORROWERS THREE YEARS TO RESCIND MORTGAGE

The Truth in Lending Act gives a borrower three days after receiving disclosures to rescind a residential mortgage transaction. If the disclosures are inaccurate, however, the borrower has three years to rescind. A case involving a refinancing transaction and a very minor disclosure error illustrates.

As of January 16, 2006, Kurt and Sandra Ponzar owed Countrywide Home Loans $491,894, secured by a deed of trust on their home. In an effort to refinance the loan, Ponzar applied for a loan from Cornerstone Mortgage. Cornerstone agreed to extend Ponzar a loan and scheduled a closing on January 12, 2006. At the scheduled closing, however, there was a dispute regarding closing costs, and the Ponzars refused to complete the closing. After some negotiations, the dispute was resolved, and the new loan closed on January 19.

At the January 19 closing, Mr. Ponzar signed a note and deed of trust dated January 19. Some of the other documents were dated January 12, however. In fact, a Cornerstone Representative asked Ponzar to backdate all of the documents to January 12. Mrs. Ponzar arrived a bit late, and signed the deed of trust and other closing documents, but did not sign the note.

The Rescission

After the closing on January 19, Cornerstone paid off the existing Countrywide Mortgage. Concerned that the interest rate on the loan was higher than originally promised, on January 23, the Ponzars sent Cornerstone two letters, one from Mrs. Ponzar and one from Mr. Ponzar, rescinding the Cornerstone loan. A Cornerstone representative contacted the Ponzars acknowledging receipt of the letters and tried to resolve the problems. Mr. Ponzar then entered into negotiations to obtain a two year loan bearing five percent interest, but the parties were unable to reach an agreement. On March 6, Cornerstone notified the Ponzars that they had a "binding mortgage obligation," and on April 5, Cornerstone filed its deed of trust

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against the Ponzars' residence.

In July, Cornerstone filed suit against the Ponzars in a Missouri court. Cornerstone asked the court to determine whether the Ponzars had properly rescinded their loan and also sought to foreclose on the home. The court held that the Ponzars had failed to rescind properly and granted the bank judgment against both defendants. On appeal, however, a Missouri appellate court reversed.

No Signature, No Liability

First off, the court held that Mrs. Ponzar was not liable on the note. While she may have signed the deed of trust, Mrs. Ponzar never signed the note. Because she did not sign the note, she was not obligated on the note, nor did she have any obligation to return the proceeds of the loan to Cornerstone. Thus, the appeals court reversed this aspect of the trial court's decision.

The court then turned to the question of rescission. The court noted that under the Truth-in-Lending Act, a borrower has three days after receiving disclosures to rescind a mortgage loan. In this case, the parties disagreed as to the date that the loan was consummated. Cornerstone argued that the loan that was granted on January 19 was merely a modification of the loan granted on January 12. Thus, according to Cornerstone, the Ponzars' January 23 notice of rescission came too late to be effective. The Ponzars contended that the loan was not granted until January 19, because they had refused to sign the January 12 loan agreement. Thus, according to the Ponzars, the January 23 rescission was sent within three days of the closing. The court found, however, that regardless of the date of the loan, the Ponzars had rescinded within the time limits imposed by the Act.

The Inaccurate Disclosure

While the Act gives a borrower three days to rescind, if the lender has violated Truth-in-Lending Act disclosure requirements, the borrowers have three years to rescind. Here, Cornerstone's notice of the right of rescission, given to the Ponzars on January 12, stated that the Ponzars had until midnight on January 15 to rescind their loan. January 15, however, was a Sunday and January 16 was a legal holiday. Thus, these days were not "business days" for purposes of the Act. In reality, the borrowers had until January 17 to rescind the transaction. Because Cornerstone's notice stated that the Ponzars only had until the 15th to rescind, Cornerstone had violated the Act's disclosure requirements. Thus, the Ponzars had three years to rescind.

Finally, the appeals court found that the trial court incorrectly decided that the Ponzars' rescission was ineffective because they had failed to "tender the proceeds" of the loan at the time they exercised their right to rescind. The appeals court found that until the lender either acknowledges that the borrowers had a right to rescind or, should the lender dispute the borrower's right, until a court decides that the borrower has a right to rescind, the borrower has no further obligations. Here, Cornerstone challenged the borrowers' assertion of their right to rescind. Thus, the Ponzars had no duty to tender the proceeds at the time they sent their notice of rescission.

The court also reversed the lower court's award of interest and attorney's fees. The appeals court then sent the case back to the trial court for a determination of the parties' obligations following rescission. (*Cornerstone Mortgage, Inc. v. Ponzar*, 2008 WL 2097417 (Mo. App. May 27, 2008).)

TRANSFEREE CANNOT ENFORCE FRAUDULENTLY OBTAINED CASHIER'S CHECK

Cashier's checks have been the cause of much confusion among the courts over the years. Some courts have treated cashier's checks as cash equivalents. These courts do not allow an issuing bank to stop payment on a cashier's check. Other courts have treated a cashier's check like a note, allowing a bank to dishonor its cashier's check if the bank has a valid defense to payment.

The latest version of the Uniform Commercial Code attempts to resolve this confusion by rejecting the cash equivalency view and treating a cashier's check like a note. See U.C.C. § 3-412. Thus, under certain, limited circumstances, a bank can dishonor a cashier's check it has issued. A recent Illinois decision considered one of those limited circumstances, specifically, when the cashier's check has been fraudulently obtained.

Mary Christelle, mother of David Hernandez, president of Essential Technologies of Illinois ("ETI"), purchased a $50,000 cashier's check payable to ETI from Charter One Bank. She purchased the check with funds from her Charter One account. ETI deposited the cashier's check into its account at MidAmerica Bank. Four days after ETI deposited the check, Christelle asked Charter One to stop payment. Charter One then stopped payment and refused to honor the check when MidAmerica presented it for payment. Instead, Charter One returned the check to MidAmerica, with a "stop payment" stamp across the front of the check. When MidAmerica received the dishonored check, the bank debited the ETI account for $50,000 and returned the dishonored check to ETI. ETI's account balance soon dropped to negative $52,000 due to a series of checks that were returned for insufficient funds.

The Dispute

MidAmerica closed the ETI account and brought suit against Charter One to recover the value of the check; Charter One then brought Christelle and her son, Hernandez into the suit. After a trial, the court found that Charter One was obligated to honor its cashier's check. The court also found that Hernandez and ETI had used Christelle as a pawn in a check kiting scheme to defraud Charter One. Based on that finding, the court found that Hernandez and ETI were liable to Charter One. Charter One appealed this decision to an Illinois appeals court, and that court reversed.

In its appeal, Charter One argued that an issuing bank should be able to stop payment on its own cashier's check. The court noted that previously, Illinois courts had adopted the "cash equivalency" rule governing cashier's checks. Under this view, "a cashier's check is regarded as accepted by the act of issuance." See *Able & Associates, Inc. v. Orchard Hill Farms*, 395 N.E.2d 1138 (Ill. App. 1979). Since that decision, however, Illinois adopted the amended version of the U.C.C.'s Article 3 which treats a cashier's check as a note. Based on the revised Article 3, the court held that a bank could dishonor a cashier's check under some circumstances.

In this case, Charter One argued that ETI had obtained the cashier's check fraudulently, and the court agreed. Christelle's Charter One account never had more than $5000 in monthly activity until January 2002. At that time, Christelle's balance briefly rose to $100,000 as a result of the deposit of two, $50,000 checks that were eventually returned for insufficient funds. Moreover, Hernandez claimed the Fifth Amendment privilege against self incrimination when asked about the check and refused to testify. Thus, the appeals court held that the trial court's finding of fraud was justified.

Moreover, the type of fraud present in this case was "fraud in the inducement," as ETI fraudulently induced Charter One to issue the cashier's check. Because ETI procured the check fraudulently, ETI was not a holder in due course. Because MidAmerica obtained the check from ETI, MidAmerica's rights to the check were limited to the rights held by ETI. Thus, MidAmerica took the check subject to Charter One's defenses, including Charter One's fraud defense. For that reason, the court held that MidAmerica could not force Charter One to honor the cashier's check. (*MidAmerica Bank, FSB v. Charter One Bank, FSB*, 2008 WL 2267170 (Ill. App. June 2, 2008).)

OBSERVATION: The court's decision does not give a customer the right to stop payment on a cashier's check. The court recognized that even under the amended version of Article 3, a customer has no right to stop payment. See U.C.C. § 3-411. A bank may honor a stop payment request, but only as an accommodation for its customer. The court's opinion does permit a bank to assert defenses to payment of a cashier's check, just as it could to payment of a note.

COURT REQUIRES "CERTIFICATE OF MAILING" TO PROVE THAT BANK SENT NOTICE OF FORECLOSURE

To foreclose on a mortgage, a lender must strictly comply with all statutory requirements. Courts are generally unwilling to allow any divergence from the requirements set forth by law. One key requirement is that the lender send the borrower notice of foreclosure and the right to cure in precisely the manner set forth by state law. In a recent decision, the Maine Supreme Judicial Court refused to allow a foreclosure action to proceed because the lender had failed to follow the statutory scheme for establishing that notice had been sent.

In October 2006, Union Trust Company filed a complaint for foreclosure against William Peterson, alleging that he had defaulted on a mortgage secured by property in South Bristol, Maine. Peterson countered by arguing that he had not received notice of default from the bank or any opportunity to cure the default. He alleged that the foreclosure complaint filed by the bank was the first communication he had received since August 2006. Thus, he argued that the bank had failed to send notice as required by Maine law.

The Proof of Mailing

To prove that it had sent the required notice, the bank produced a copy of the notice of foreclosure it allegedly sent Peterson, accompanied by a bank officer's affidavit stating that the notice was sent to Peterson "by certificate of mailing." The bank, however, failed to produce either the original or a copy of the certificate. A few months later, the bank produced a bank officer's deposition, accompanied by a copy of a United States Postal Service (USPS) form maintained by the officer and stamped by the USPS on September 1, 2006, stating that a letter was mailed to Peterson on that date.

Based on all of this evidence, the trial court found for the bank. The court found that the collections officer's logbook was sufficient to meet the "certificate of mailing" requirement under Maine law. Peterson appealed

this decision, and the Maine Supreme Judicial Court reversed.

Under Maine law, a lender must send a borrower notice of default and the right to cure before foreclosing on mortgaged property. See Me. Rev. Stat. Ann. § 6111. The court noted that if the lender sends the notice via first class mail, the lender may prove compliance with the notice requirement in two ways. First, the lender may prove actual receipt. Second, the statute "deems notice to have been given three days after mailing if the mortgagee obtains a post office department certificate of mailing." See Me. Rev. Stat. Ann. § 6111(3)(B). In this case, Peterson denied receiving notice of default. Thus, the court was left with the second possibility, proof by a certificate of mailing. The court explained that a certificate of mailing must be purchased at the time mail is presented to the USPS. Moreover, the certificate of mailing is the only official record of mailing that the USPS provides.

While the bank did not produce an actual certificate of mailing, the bank argued that the bank officer's assertion that he had sent notice by certificate of mailing was sufficient to satisfy the statute. The bank also pointed to the bank officer's logbook, which had been stamped by the USPS, to prove that the officer had sent the notice and obtained the certificate of mailing.

The court rejected the bank's arguments. First, the officer's affidavit indicating that he had obtained a certificate of mailing did not substitute for the actual certificate. Second, while USPS regulations state that the postal service will affix a stamp to a mailer's logbook if a certificate is purchased, the logbook page in question here did not clearly indicate whether the fee paid by the bank was for purposes of obtaining a certificate of mailing.

Based on these findings and given Peterson's denial of receipt, the court concluded that an issue remained regarding whether the bank had sent proper notice as required by Maine law. To resolve this factual dispute, the court returned the case back to the trial court. (*Camden National Bank v. Peterson*, 2008 WL 2098096 (Me. May 20, 2008).)

OBSERVATION: In its decision, the court emphasized the importance of strict compliance with mortgage foreclosure statutes, particularly in residential foreclosures. The court noted that trial courts should hesitate before granting banks summary judgment and allowing a foreclosure to proceed when a borrower challenges the foreclosure process.

COURT LIMITS GUARANTOR'S LIABILITY DUE TO CREDITWORTHINESS OF BORROWER

Even an unconditional guaranty may be subject to limiting conditions. While a typical unconditional guaranty can extend to debts incurred by the borrower long after the guaranty is signed, oftentimes a guaranty will not apply to debts incurred by the borrower if and when the borrower meets the lender's standard of creditworthiness. A decision of the Nebraska Supreme Court illustrates how such a provision operates.

In November 1995, Brad Betts obtained a $6200 loan from the First National Bank of Unadilla, Nebraska. Lacking assets to secure the loan, Brad's father Jack signed a guaranty. In April 1996, Brad renewed the loan in the amount of $7668. Jack again signed a guaranty covering the renewal. Once again, in July 1998, Brad renewed the loan, this time for $11,951. This loan was secured by two used cars that Brad owned, as well as his father Jack's guaranty. This last guaranty led to the lawsuit that produced the court's decision.

On May 8, 2000, Brad and his wife, Elizabeth Betts, took out a new, $3900 loan from the bank. This was not a renewal loan, and Brad's father Jack did not guarantee this loan. At the time the loan was granted, both Brad and Elizabeth were working, with a combined income of $52,880.

Finally, on May 15, 2000, Brad and Elizabeth obtained a loan for $19,418 (the 2000 loan). This loan was a renewal of the 1998 and May 8, 2000 loans, and included an additional $6751 in new funds and $3118 in credit insurance. Brad later testified that the bank told him that his father Jack did not need to guaranty this loan because both Brad and Elizabeth were employed. This final loan was secured by a deed of trust and second mortgage on Brad and Elizabeth's home.

In December 2003, the bank received a notice stating that Brad and Elizabeth's home was to be sold at a trustee's sale. The sale occurred, but as a second mortgage holder, the bank received none of the proceeds. As a result, the bank sought to collect the remaining balance from Jack, pursuant to his 1998 guaranty.

Enforcing the Guaranty

To enforce the guaranty, the bank brought suit against Jack in a Nebraska county court, alleging that

Jack was liable to the tune of $11,951, plus interest accruing after August 23, 2002, the date the bank received the last payment from Brad. In response, Jack argued that his obligation under the 1998 guaranty was terminated by the 2000 loan, as the bank granted that loan based on Brad and Elizabeth's creditworthiness.

At trial, a bank officer testified that at the time the bank granted Brad and Elizabeth the 2000 loan, neither met the bank's standard's for creditworthiness. After the trial, the court found that the 1998 guaranty was "an absolute unconditional continuing guaranty, which continued until all of Brad and Elizabeth's indebtedness was discharged." In addition, the court found that Brad and Elizabeth failed to meet the bank's standards for creditworthiness when they obtained the 2000 loan. Thus, the court held that the bank was entitled to judgment, plus the requested interest.

Jack appealed to a Nebraska district court, and on appeal, the court held that Jack's guaranty covered the 1998 loan and any extensions, renewals or replacements. Unlike the first court, however, the district court held that the guaranty continued in force only until the 1998 was paid off. The court also held that the 1998 guaranty did not cover any of Brad and Elizabeth's loans granted after Brad and Elizabeth met the bank's standards of creditworthiness. Moreover, the court found that at the time the bank extended Brad and Elizabeth the 2000 loan, the couple did meet the bank's standards of creditworthiness. Thus, the court held that the bank could not enforce Jack's guaranty. The bank appealed this decision to the Nebraska Supreme Court.

The Language of the Guaranty

On appeal, the court focused on the language of the 1998 guaranty. The guaranty stated that it did not cover any indebtedness "for which the Borrower meets the Lender's standard of creditworthiness based on Borrower's own assets and income. . . ." Moreover, the 1998 guaranty was limited to a principal of $11,951. Thus, under the terms of the guaranty, the court had to determine whether Brad and Elizabeth met the bank's standard for creditworthiness.

The court noted that the standard for creditworthiness was based on Brad and Elizabeth's "own assets and income. . . ." The guaranty, however, did not otherwise define creditworthiness. The bank's own financial statement indicated that Brad and Elizabeth had sufficient net worth to cover the debt. At the time the bank granted the loan, the couple's net worth was $23,568, less than the principal of the loan. In addition, the bank obtained a second mortgage on their home to secure the debt. While the home was subject to a $63,500 first mortgage, its value was $77,000. Thus, based on these figures, the court concluded that the couple met the bank's standard of creditworthiness at the time the bank granted the 2000 loan.

Putting aside the couple's financial statement, the bank argued that the standard of creditworthiness was a subjective standard, and included the couple's history of late payments. The court found, however, that the guaranty explicitly limited creditworthiness to a consideration of the couple's assets and income. Thus, the court refused to consider past conduct as an indication of creditworthiness.

The court next considered whether the couple's creditworthiness absolved Jack of all responsibility for the 2000 loan. Jack's 1998 guaranty provided that only "full payment and discharge" would relieve him of his obligations under the guaranty. While the 2000 loan was based on Brad and Elizabeth's creditworthiness, $5636 of the loan was designated to repay the existing balance on the 1998 loan. Because this indebtedness had never been repaid, the court held that under the language of his guaranty, Jack remained liable for that amount. (*First National Bank v. Betts*, 748 N.W.2d 76 (Neb. 2008).)

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