

BB REVIEW

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BALCH & BINGHAM CONDUCTS CRCT INVESTIGATION AT THE REQUEST OF FORMER GOVERNOR

Elementary and middle public school students in Georgia take the Criterion Reference Competency Test ("CRCT") each year as a part of the No Child Left Behind legislation. In early 2010, the Governor's Office of Student Achievement received an erasure analysis from the testing company that issues and grades the CRCT. The results of the erasure analysis indicated a statistically high number of wrong-to-right erasures--the statistics showed that the number of wrong-to-right erasures was so high that it could not have happened by chance. Former Governor Sonny Perdue ordered a number of school districts around the state to conduct internal investigations to determine the cause of the high number of wrong-to-right erasures. Governor Perdue determined that the Atlanta Independent School System's ("APS") and the Dougherty County School System's ("DCSS") investigations were inadequate. Accordingly, he decided to conduct an investigation on behalf of the state. He turned to Mike Bowers, former Attorney General and partner at Balch & Bingham, Bob Wilson, former DeKalb County District Attorney, and Richard Hyde, investigator with Balch & Bingham, to conduct the investigation. On August 26, 2010, Governor Perdue issued an Executive Order appointing Bowers, Wilson, and Hyde as Special Investigators. Bowers and Wilson were recently appointed Special District Attorneys by Fulton County District Attorney Paul Howard as well.

Since August, four attorneys at Balch & Bingham have been working with Wilson's office, the GBI, and the Fulton County District Attorney's office to investigate thousands of educators at 58 schools in Atlanta. Governor Deal is continuing the investigation. When the investigation of APS is complete, the team will turn to DCSS.

A FAVORABLE DEVELOPMENT FOR BANKS SEEKING COVERAGE UNDER THEIR FINANCIAL INSTITUTION BONDS

On March 16, 2011, the Eleventh Circuit Court of Appeals released a decision that should be helpful to banks seeking to recover under their financial institution bonds for losses that result from the bank's extension of credit in reliance on forged, altered or counterfeit instruments. In *Beach Community Bank v. St. Paul Mercury Insurance Company*, No. 10 - 11049 (11th Cir. Mar. 16, 2011), the Eleventh Circuit reversed a summary judgment for St. Paul Mercury Insurance Company, finding questions of fact as to whether a financial institution bond issued to Beach Community Bank provided coverage for losses it suffered upon the default of a loan secured by a forged guaranty. In reaching its decision, the Court held that the Florida district court had misinterpreted the bond in requiring that Beach Community Bank prove that it "would have been able to collect on the

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loan but for the forged signature” on the guaranty. *Id.* at 8.

The case involved a loan of \$10 million from Beach Community Bank to Dellwood Properties, Inc., to finance the purchase of beachfront property in Panama City Beach, Florida. Dellwood was a Florida corporation, and its sole officer, director and shareholder was Charles Faircloth, a 75-year-old developer. The bank’s loan committee approved the loan to Dellwood conditioned on the receipt of guaranties from Mr. Faircloth and his wife, Juanita Faircloth. The bank obtained the guaranties to secure property held in a tenancy by the entirety, and had presumed that Mr. Faircloth shared ownership of many of his assets with his wife. Mr. Faircloth died and Dellwood defaulted on the loan. After the loan default, the bank learned that Juanita Faircloth’s signature on her guaranty was a forgery. While Mr. Faircloth had assets of \$130 million in 2004, his estate had less than \$100,000 in cash and several million in debt by the time the bank discovered its loss.

Beach Community Bank notified St. Paul of the loss and sought coverage under the forgery provision of the bank’s financial institution bond. When St. Paul refused coverage, the bank sued St. Paul to recover under the bond. The bank alleged that it had suffered a loss equal to the amount of its loan resulting directly from its reliance on the forged guaranty. St. Paul first argued that Beach Community had failed to satisfy the bond’s causation requirement. St. Paul argued that the bank did not suffer a loss that was directly caused by the forgery because Mrs. Faircloth had no assets from which the bank could have collected even if the signature on her guaranty had been authentic. Second, St. Paul argued that the bank did not satisfy the bond’s requirement that the bank physically possess the guaranty when it extended credit, because the loan was made when the guaranty was presented to Mr. Faircloth’s business associate who closed the loan. Third, St. Paul argued that the loan was not made in good faith because the bank

made no effort to verify the authenticity of the signature on the guaranty.

The district court granted summary judgment for St. Paul on its first argument, finding that the loss did not result directly from the bank’s reliance on the forgery because the purported guarantor had few assets when the default occurred, such that the bank could not have recovered even if the guaranty had been authentic. The district court concluded that the bank’s loss was caused by the guarantors’ diminished assets and the crashed real estate market as opposed to the forged guaranty.

The Eleventh Circuit disagreed and reversed the summary judgment for St. Paul. Applying Florida law, the Court held that Beach Community Bank had offered sufficient evidence that it had suffered loss resulting directly from its extension of credit to Dellwood Properties based on the forged guaranty. With respect to the Eleventh Circuit’s ruling with respect to the bond’s causation requirement, the Court declined to apply tort principles (i.e., a proximate cause analysis), to its interpretation of the bond’s requirement that the bank’s loss “result directly from . . . the extension of credit . . . on the faith of a forged security instrument.” *Id.* at 2. The bank’s proof that it would not have extended credit except for the guaranty was sufficient to establish that it suffered a loss resulting directly from the forgery.

Notably, the Court made the following significant findings that should be helpful to banks in recouping losses resulting from reliance on forged, altered or counterfeit instruments:

- The measure of the bank’s loss was the amount of credit extended, not the amount that could be recovered in a hypothetical collection effort.
- The decline in the guarantors’ wealth had nothing to do with the extension of credit and did not affect coverage for the loss.

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•The coverage that financial institution bonds provide for losses that result directly from forgery or other covered fraudulent conduct is unaffected by events that follow the fraudulent act, such as economic downturn, bankruptcy or death of a creditor that would have limited recovery.

•“Insurance of guaranties would be illusory if a default by the borrower or decline in his wealth severed the direct causal relationship between reliance on a forged guaranty and a loss because a guaranty is enforced only when the borrower defaults and is unable to pay.” Id. at 12.

•The Court disagreed that its interpretation would transform the bond into credit insurance. Observance of the direct causation, physical possession, reliance and good faith requirements prevented the bond from becoming credit insurance.

In reaching its conclusions, the Eleventh Circuit distinguished numerous cases from other jurisdictions that held a bank did not satisfy the bond’s requirement that a loss “result directly from” reliance on a forgery when the forged documents described non-existent collateral or misrepresented the value of the collateral. Id. at 14. The Court found that Juanita Faircloth’s guaranty, if authentic, would have had value. The Court went so far as to say, “If Juanita were to win the Florida lottery, for example, Beach Community could attach her winnings.” As such, the Court found that the “bond’s requirement of a loss resulting directly from the extension of credit was sufficient.” Id. at 15. Similarly, the Court concluded that while reliance is a prerequisite to coverage, “we cannot hold that coverage is limited to the value of assets held by Juanita individually at the time the loan was approved.” Id. at 19.

The Court also concluded that questions of fact prevented summary judgment based on St. Paul’s alternative arguments. St. Paul had argued that the bank did not satisfy the bond’s physical possession requirement because it did not possess the forged

guaranty at the time credit was extended. However, the Court found that a question of fact existed whether Mr. Faircloth’s business associate who closed the loan was acting as an agent for Beach Community Bank. The bank had obtained loan participation coverage under the bond, which allowed the requirement of actual physical possession to be satisfied when a correspondent representative authorized to possess documents such as guaranties possesses them on behalf of the bank. The Court likewise rejected St. Paul’s argument based on the bond’s “good faith” requirement. The fact that the bank failed to verify the authenticity of the signatures could be described as nothing more than negligence, which is insufficient to convert good faith into bad faith.

The Eleventh Circuit’s decision is helpful to banks seeking coverage for losses resulting from forged, altered and counterfeit security instruments under their financial institution bonds. The decision supports that as long as the fraudulent instrument would have had some value to the bank in extending credit, the loss amount is the loan amount as opposed to the amount collectible had the fraudulent instrument been legitimate. Further, the decision is favorable to banks in obtaining a recovery of their loan losses even though the underlying loan collateral has lost value since the original transaction as a result of a down economy.

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Balch & Bingham LLP’s Insurance Dispute Litigation Focus group regularly provides advice, coverage analyses and litigation support to banks seeking recovery under their financial institution bonds and other insurance policies.

BALCH RETURNS A \$1 MILLION DOLLAR VERDICT

Brant Pettis and Jonathan Dyal of the Gulfport office won a week long jury trial on April 25, 2011.

Balch represented an orthopedic surgeon in a business dispute with nine doctors who were former business



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partners. The nine doctors filed suit against the Firm's client for breach of fiduciary duties, breach of covenants not to compete and for a declaratory relief that they owed him no money under their operating agreement other than return of his initial capital contribution in the amount of \$55,000. The Firm counter-sued seeking \$992,000 in damages plus interest under the proper buyout provision of the operating agreement in effect at the time he left the partnership. In addition to claiming breach of fiduciary duties and breach of covenants not to compete, the nine doctors attempted to amend the operating agreement and back date same in effort to avoid paying him the \$992,000.

The jury returned a verdict for the full \$992,000, plus interest, for a total award of \$1,089,311.54.

BALCH SETS THE STANDARDS IN COPYRIGHT CASES

Kimberly Powell, Dorman Walker and Will Hill Tankersley have organized and are part of a working group of twelve lawyers (and one retired judge) to draft and organize the first ever copyright pattern jury instructions for the United States 11th Circuit Court of Appeals.

DODD-FRANK ACT'S PROFOUND AFFECT ON THE REGULATION OF CONSUMER FINANCIAL PRODUCTS AND RELATED LITIGATION

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), signed into law on July 21, 2010, is often referred to as the most sweeping financial reform legislation since the Great Depression. Among other things, the Act's amendments to both the Truth in Lending Act ("TILA") and the Real Estate Settlement and Procedures Act ("RESPA") profoundly affect the regulation of consumer financial products and related litigation. First, the Act amends TILA in several significant ways as it relates to mortgage origination and residential mortgage loans. Under these amendments, consumers may now file

actions against mortgage originators for duty of care and steering incentive violations. In addition, the damages available to consumers under these the new claims can include three times the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the violations, plus reasonable attorneys' fees. Also, the Act amends TILA so as to require a creditor to make a good faith determination that the consumer has a "reasonable ability to repay" a mortgage loan by considering a variety of factors listed in the amendments. If a mortgage originator or creditor violates the newly created prohibitions on steering incentives, or fails to verify a consumer's ability to repay, consumers may assert the defenses of setoff or recoupment in a subsequent foreclosure or collection action. Under the Act, the amount of setoff or recoupment is equal to the amount of damages the consumer would be entitled to as if the consumer had brought a private action for damages for the violations.

Second, the Act also significantly amends RESPA. In general, these amendments make it more likely that servicers will be exposed to litigation by providing for higher damages for consumers and stricter timelines for servicers to respond to Qualified Written Requests.

These changes, though significant, are likely only the beginning. As new regulations required to be promulgated under the Act are issued and implemented, the Act's effect on consumer financial products and related litigation will almost certainly continue to increase.