LENDER LIABILITY LAW REPORT

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District of Columbia Federal Court Grants Mortgagee Summary Judgment on Claim that It Conspired to Violate the False Claims Act by Submitting Forged Documents to HUD but Declines to Dismiss Other Claims

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The United States District Court for the District of Columbia granted a mortgage lender's motion for summary judgment as to claims against the lender for conspiracy to violate the False Claims Act and for actual damages thereunder, but denied the lender summary judgment as to all other claims against it arising out of its submission of forged documents to HUD. *United States of America, ex rel. Fago v. M&T Mortgage Corp.*, Civ. Action No. 03-1406 (D.D.C. Oct. 2, 2007). The court reasoned that a lender cannot conspire with itself or its employees and therefore granted summary judgment under the "intra-enterprise conspiracy doctrine." The court also found that the plaintiff failed to prove any proximately caused damage resulting from alleged forgeries on documents by the lender's employees and granted the lender summary judgment as to the claim for damages under the False Claims Act. However, the court refused to dismiss claims for statutory fines.

▸ **FACTS**. M&T Mortgage Corp. ("M&T") engaged in the home mortgage lending business as a subsidiary of M&T Bank. Ann Fago began work in M&T's post-closing department in July 2001. The post-closing department would receive mortgage loan binders and, as part of Fago's duties, she and others would review the binders to make sure they were complete so that they could be sent to the United States Department of Housing and Urban Development ("HUD") to be insured by the government.

HUD required that mortgage loan binders be submitted within sixty days of closing or there would be a more cumbersome administrative process to go through to obtain the HUD insurance. Because of increased volume in applications in 2002, and to avoid problems with the 60-day rule, Fago and others in the post-closing department began forging signatures on unsigned documents contained in the mortgage loan binders that they received prior to their submission to HUD. A total of 53 mortgage loan binders submitted to HUD contained forged signatures.

▸ **LITIGATION**. The United States sued M&T at the request of Fago alleging violations of the False Claims Act ("FCA") in that (i) M&T knowingly presented false claims to the government in violation of 31 U.S.C. § 3729(a)(1), (ii) it knowingly made or used false records or statements so that the government would pay false claims in violation of 31 U.S.C. § 3729(a)(2), and (iii) it engaged in a conspiracy to defraud the government by having false claims paid in violation of 31 U.S.C. § 3729(a)(3). The government further sought a declaratory judgment that M&T's forgery of documents violated 31 U.S.C. § 3729(a)(2) and injunctive relief.

On December 30, 2005, M&T filed a motion for summary judgment as to 15 of the loan files. Thereafter, on April 11, 2006, the court struck four of the declarations submitted by M&T on the ground that the witnesses had not been disclosed as required by Fed. R. Civ. P. 26(a)(1). See *United States ex rel. Fago v. M&T Mortgage Corp.*, 2006 WL 949899 (D.D.C. Apr. 11, 2006). That same day, M&T filed a supplemental motion for summary judgment as to the other 38 loan files. Once again, the government

filed a motion to strike declarations and supplemental interrogatory responses that M&T relied upon in support of its summary judgment motion.

▸ Motion to strike. The government argued that three of the declarations submitted by M&T in support of its summary judgment motion should be stricken because the witnesses had not been identified in discovery. M&T argued that the witnesses were rebuttal witnesses and that there is no obligation to disclose the identity of rebuttal witnesses. Moreover, it asserted that it produced the documents underlying the declarations prior to the close of discovery.

The court struck the declarations pursuant to Fed. R. Civ. P. 37(c)(1), finding that the identity of rebuttal witnesses must be disclosed pursuant to Fed. R. Civ. P. 26(a)(1) which requires disclosure of "any individuals 'likely to have discoverable information that the disclosing party may use to support its claims or defenses, unless solely for impeachment.'" Moreover, the court found the non-disclosure not to be harmless, therefore requiring the declarations to be struck under Rule 37(c)(1) because the declarations went to the issue of whether the signatures on documents were forged, which was a central issue in the case. The government had not been afforded an opportunity to depose the witnesses or otherwise challenge their declarations.

The government further argued that the declaration of a handwriting expert submitted by M&T should be stricken because the declaration was re-submitted after an Order previously had been entered striking it. The court agreed, noting that although discovery had been reopened as to 38 of the loans, it was not reopened for all purposes. Because the expert's declaration did not relate to the 38 loans, it was found to have been improperly submitted and was stricken. The court reasoned that plaintiff had a right to rely upon the court's prior Order. Finally, the court struck amended answers to interrogatories, ruling that M&T was not entitled to amend its answers after the close of discovery.

▸ A lender's liability under 31 U.S.C. § 3729. M&T argued that the government failed to state a claim for knowingly presenting a false or fraudulent claim for payment or approval under 31 U.S.C. § 3729(a)(1), or for knowingly making, using or causing to be made or used a false record or statement to get a false or fraudulent claim paid or approved by the government under 31 U.S.C. § 3729(a)(2) because she did not allege that M&T's actual claims for reimbursement, as opposed to the applications to HUD for insurance, were false or fraudulent.

The court found that a claim had been made out because the loans actually defaulted. The court noted that "a lending institution's application for credit insurance under [an] FHA program is not a 'claim' as that term is used in the False Claims Act." *United States v. McNinch*, 356 U.S. 595 (1958). Moreover, "[i]t is generally accepted that the false application for a guaranteed loan … establishes only an 'inchoate' violation … that does not ripen into a claim actionable under the statute until a later event of legal consequences between the lender and the government." See, e.g., *United States v. Ekelman & Assoc., Inc.*, 532 F.2d 545, 552 (6th Cir. 1976); *United States v. Ettrick Wood Products, Inc.*, 683 F. Supp. 1262, 1263-64 (W.D. Wisc. 1988); *United States v. Van Oosterhout*, 96 F.3d 1491, 1494 (D.C. Cir. 1996). However, because the loans defaulted, the court reasoned that plaintiff's "inchoate" claims ripened into actual claims when M&T sought payment from HUD.

▸ A lender's liability on conspiracy claim/intra-corporate conspiracy doctrine. Plaintiff alleged that M&T engaged in a conspiracy to defraud the government by having false or fraudulent claims paid in violation of 31 U.S.C. § 3729(a)(3). M&T argued that the "intra-corporate conspiracy doctrine" barred the claim because under that doctrine "a corporation cannot conspire with its employees, and its employees, when acting in the scope of their employment, cannot conspire among themselves." *Brown v. Sim*, 2005 WL 3276190 at *3 (D.D.C. Sept. 30, 2005); *McAndrew v. Lockheed Martin Corp.*, 206 F.3d 1031, 1036-37 (11th Cir. 2000). The court granted M&T's motion for summary judgment as to the conspiracy claim because plaintiff only alleged that M&T conspired with its employees.

▸ Materiality of alleged false statements. To state a claim under the FCA, a plaintiff must allege and prove that the alleged false statements were material. See *United States v. TDC Mgmt. Corp.*, 24 F.3d 292, 298 (D.C. Cir. 1994); *Tyger Constr. Co. v. United States*, 28 Fed. Cl. 35, 55 (1993). For a false statement to be material it must have "a natural tendency to influence agency action or is capable of influencing agency action." *United States ex rel. Berge v. Bd. of Trs. of the Univ. of Alabama*, 104 F.3d 1453, 1460 (4th Cir. 1997); *Hays v. Hoffman*, 325 F.3d 982, 992 (8th Cir. 2003).

M&T argued that HUD guidelines spell out what the agency considers to be material when insuring a loan. It asserted that Appendix 17 to the *Direct Endorsement Program Handbook 4000.4* sets forth 11 specific documents in the loan binder that HUD considers in insuring

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a loan, which according to M&T is an exclusive list. Because many of the documents containing alleged forged signatures were not on the list, M&T argued that any falsities regarding such documents could not be material.

The court rejected M&T's argument because HUD is authorized "to determine if there is any information indicating that any certification or required document is false, misleading, or constitutes fraud or misrepresentation on the party of any party." 24 C.F.R. § 203.255(c). Hence, the court found that HUD is specifically authorized to consider "any information" in determining whether a loan application is misleading, false or fraudulent. Indeed, nothing in the regulation precludes HUD from considering any particular document in determining whether a loan application is false.

HUD Handbook 4000.4 § 4-7 specifically states that "[t]he pre-endorsement review is confined to those items specified in this paragraph. No further review is required or authorized prior to endorsement unless HUD has reason to suspect fraud in the origination process." Moreover, Appendix 17, on which M&T relied, is only a "checklist" to assist those seeking endorsement to submit all the required information; it is not an official regulation, and there is no suggestion in Appendix 17 that it is meant to be an exclusive list or that HUD is precluded from considering other information. M&T's own expert witness testified that HUD sometimes "looked at more documents than what are required under the regulations and its own handbook guidance," and that HUD would have found certain documents not in Appendix 17 to have been critical to HUD's decision to endorse a loan.

The court found summary judgment to be inappropriate on the issue of materiality because "a genuine issue of material fact remains regarding whether the allegedly forged signatures and false certifications were 'capable of influencing' or had a 'natural tendency to influence' … HUD's decision to endorse the loans or later seek indemnification."

▸ **Causation**. M&T argued that it was entitled to summary judgment because the plaintiff could not prove a causal link between the forged signatures and damage suffered by the government. The court noted, however, that "the submitter of a 'false claim' or 'statement' is liable for a civil penalty, regardless of whether the submission of the claim actually causes the government any damages." See *United States ex rel. Schwedt v. Planning Research Corp.*, 59 F.3d 196, 199 (D.C. Cir. 1995). The second form of liability for violation of the FCA "is for damages actually caused the Government because of the submission of the false claim" and, as to this liability, a plaintiff must prove that the defendant "caused the Government to pay claims 'because of' the alleged false statements." *Id.*; 31 U.S.C. § 3729(a).

The court found many facts going to causation to be disputed, but upon close analysis found the disputed facts not to be material "when considered through the lens of the controlling causation standard in this Circuit." Under the causation standard adopted in the Federal Circuit, "the submitter of a false claim should be liable only for those damages that arise because of the falsity of the claim, i.e., only for those damages that would not have come about if the defendant's misrepresentations had been true. See, e.g., *United States ex rel. Schwedt*, 59 F.3d at 200. This standard has been adopted by the Third and Fifth Circuits. See, e.g., *United States v. Miller*, 645 F.2d 473, 475-76 (5th Cir. 1981); *United States v. Hibbs*, 568 F.2d 347, 351 (3d Cir. 1977). But cf. *United States v. First Nat'l Bank of Cicero*, 957 F.2d 1362, 1374 (7th Cir. 1992).

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The court concluded that plaintiff was required to show that "the specific misrepresentations made to HUD in this case were the direct and proximate cause of HUD's losses and not merely the "but for" cause of those losses." See *United States v. Spicer*, 57 F.3d 1152, 1157 (D.C. Cir. 1995).

Plaintiff argued that a genuine issue of material fact existed regarding causation because, had M&T told HUD the truth (i.e., that not all signatures on documents in the loan binders were genuine), HUD would have rejected the entire application. The court found this argument mistakenly construed the Schwedt and Spicer cases to apply a less restrictive "but for" causation test whereas the government must go beyond a "but for" analysis and prove that the false statements were the proximate cause of the actual damages sustained by the government.

The court found that the government failed to present any evidence that the presence of non-genuine signatures on documents was in any way related to the actual reason that borrowers defaulted. Hence, the court found that M&T was entitled to summary judgment as to plaintiff's claims for actual damages to the government relating to submission of the 51 loan binders at issue. The court found, however, that plaintiff nevertheless was entitled

to continue to seek statutory civil penalties under the FCA, as such penalties do not require a showing of causation.

▸ **Knowledge of falsity of statements.** To prevail on its FCA claim for civil penalties, the government was required to prove that M&T "knowingly presented a false or fraudulent claim" to the government. E.g., *United States ex rel. Ervin & Assocs, Inc. v. Hamilton Sec. Group, Inc.,* 370 F. Supp. 2d 18, 40 (D.D.C. 2005). A person acts "knowingly" if he or she "(1) has actual knowledge of the information; (2) acts in deliberate ignorance of the truth or falsity of the information; or (3) acts in reckless disregard of the truth or falsity of the information." See 31 U.S.C. § 3729(b).

M&T argued that the government could not prove that M&T knowingly submitted false certifications to HUD, as the certifications were made "to the best of its knowledge" and therefore could not be said to be either true or false, relying upon *United States v. Ekelman & Assocs., Inc.*, 532 F.2d 545, 549 (6th Cir. 1976)("*Eckelman*"). The court distinguished *Eckelman*, however, and expressly found that it did not stand for the proposition that a certification made to the best of one's knowledge cannot, as a matter of law, form the basis of an FCA claim. The court relied upon two cases cited by the government to find that, because the government presented evidence that M&T employees themselves forged the signatures on the loan documents and then M&T falsely certified to HUD that all documents were properly executed, a genuine issue of material fact was raised as to whether the certifications were knowingly false. See *Grand Union Co. v. United States*, 696 F.2d 888, 890-91 (11th Cir. 1983); *Harrison v. Westinghouse Savannah River Co.*, 352 F.3d 908, 917 (4th Cir. 2003).

▸ **Treble damages under the FCA.** M&T asserted that treble damages under the FCA were punitive in nature and therefore implicated the Excessive Fines Clause. See *Vermont Agency of Natural Res. v. United States ex rel. Steve*, 520 U.S. 765, 784-85 (2000)(states not subject to FCA liability because punitive nature of damages under FCA is contrary to presumption against imposition of punitive damages against government entities). The court noted that several circuits had applied the Excessive Fines Clause to FCA damage awards. See, e.g., *United States v. Mackby*, 339 F.3d 1013, 1016 (9th Cir. 2003).

A punitive damage award will violate the Excessive Fines Clause "if it is grossly disproportional to the gravity of a defendant's offense." *United States v. Bajakajian*, 524 U.S. 321, 334 (1998). "[T]he question [of] whether a fine is constitutionally excessive calls for the application of a constitutional standard to the facts of a particular case." Id.

In declining to consider M&T's argument as being premature, the court reasoned that Excessive Fines Clause issues only have been addressed "after a fine had been imposed on the defendant and the contours of the offence were well established." Because numerous issues of material fact remained to be determined at trial, the court found the argument to be premature.

▸ **Lender's vicarious liability.** M&T argued that it could not be held vicariously liable for the acts of its employees, relying on *Kolstad v. Am Dental Ass'n.*, 527 U.S. 526 (1999) and *United States v. S. Maryland Hme Health Servs.*, 95 F. Supp.2d 465 (D. Md. 2000) ("Southern").

"[A]n employer is not vicariously liable under the FCA for wrongful acts undertaken by a non-managerial employee unless the employer had knowledge of her acts, ratified them, or was reckless in its hiring or supervision of the employee." Id. at 468-69. The court noted, however, that the *Southern* case was never appealed, has been criticized, and goes against the great weight of authority in FCA cases. See, e.g., *United States ex rel. Shackelford v. Am. Mgmt.*, Inc., 484 F. Supp.2d 669, 673-76 (E.D. Mich. 2007); *United States v. O'Connell*, 890 F.2d 563, 567-69 (1st Cir. 1989), *United States v. Hanger One, Inc.*, 563 F.2d 1155, 1158 (5th Cir. 1977); *United States ex. rel Bryant v. Williams Bldg. Corp.*, 158 F. Supp.2d 1001, 1006-09 (D. S.D. 2001).

The court declined to choose from the array of alternate standards available because it found that, even under the *Southern* standard proffered by M&T, summary judgment would be inappropriate given the existence of disputed issues of material fact. A genuine issue of material fact was found to exist as to whether the employees involved with the forgeries were "clerical level employees without any management responsibility."

▸ **Indemnification and damages under the FCA.** M&T argued that it could not be held liable based on loans as to which it indemnified HUD. The court re-

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jected this argument and held that indemnification does not eliminate M&T's potential liability. Moreover, the court held that, regardless of whether the plaintiff can prove any actual damage suffered by the government, plaintiff may be entitled to statutory penalties.

M&T also argued that to determine actual damages any compensatory payments must first be subtracted from the actual damages and the reduced figure should then be trebled. The government argued that actual damages first should be trebled and then any compensatory payments made to the government should be deducted. The court found that *United States v. Bornstein*, 43 U.S. 303 (1976), supported the government's view of the proper methodology to apply in calculating damages. Moreover, the court held that this approach maximized the deterrent impact of the treble damages provision and best comported with the language and purpose of the FCA.

Maryland Appellate Court Holds that Lender Cannot Validly Effectuate a Waiver of the Borrower's Right to Prepay His Mortgage Loan Without Penalty

The Maryland Court of Appeals held that a mortgage lender cannot validly cause a borrower to waive his right to prepay his mortgage without penalty. The court rejected the argument that the charge incurred for prepaying the mortgage was actually a charge incurred, but waived (so long as there was no prepayment), at closing. *Bednar v. Provident Bank of Maryland, Inc.*, No. 142 (Md. Ct. App. Dec. 13, 2007).

Andrew Bednar obtained a second mortgage from Provident Bank of Maryland, Inc. (the "Bank") on August 29, 2003. The promissory note and security agreement provided that the Bank "elects to make this loan under subtitle 10 of Title 12 of the Commercial Law Article of the Annotated Code of Maryland and federal law."

In addition to signing a promissory note and security agreement, Bednar signed a "Closing Costs Waiver Certificate" which provided that "[a]s a condition to receiving a waiver of closing costs, you agree not to close the account for a minimum period of three years from the date of settlement. If the account is closed during the first three year period, the waiver will be rescinded and the closing costs will be added to the balance of the account and will be due and payable immediately, without notice or demand, to Provident Bank." The closing costs that were not paid by Bednar pursuant to the closing costs waiver certificate totalled $681.

Two years after the closing, Bednar refinanced with another lender and fully prepaid his loan from the Bank. In addition to all outstanding principal, the Bank collected $681 from Bednar without informing him that he was being so charged.

▸ Litigation. Bednar filed a class action suit against the Bank on December 14, 2005 in Maryland state court. He alleged that, in collecting the additional $681.00, the Bank violated Credit Grantor Closed End Credit Provisions ("CLEC"), §§ 12-1001 *et seq.* of the Commercial Law Article and that, in so doing, the Bank violated the Consumer Protection Act, §§ 13-301(1), (3) and (9). He also alleged that the charge violated the Interest and Usury laws, §§ 12-101 *et seq.* of the Commercial Law Article and the Secondary Mortgage Loan Law, §§ 12-401 *et seq.* of the Commercial Law Article.

The Bank moved to dismiss the class action complaint on March 29, 2006. The court granted in part and denied in part the motion. The court dismissed the usury and secondary mortgage law claims, but denied the Bank's motion as to claims under CLEC and the Consumer Protection Act.

The Bank subsequently filed a motion for summary judgment as to the CLEC and Consumer Protection Act claims and Bednar cross-moved for summary judgment. The Bank contended that the deferred payment of the closing costs was approved by the Maryland Commissioner of Financial Regulation and all other state and federal regulatory agencies that have considered the issue.

The court granted the Bank's motion and denied the cross-motion, concluding that the loan closing fees charged and disclosed by the Bank were in accordance with Section 12-1005(b) of the Commercial Law Article and that the Bank "did not violate CLEC by 'recapturing the closing costs upon the Plaintiff's payment of his loan because the costs were imposed at the time of the loan closing, not at the time of prepayment of the loan." The trial court declined to consider interpretative letters of the Maryland Commissioner of Financial Regulation or those of any other regulatory body. Because the court found that CLEC had not been violated, it found that the Bank did not violate the Consumer Protection Act, §§ 13-101 *et seq.* of the Commercial Law Article. Bednar appealed, and the appellate court reversed.

▸ Violation of CLEC. Bednar argued on appeal that summary judgment erroneously was granted the Bank because the Bank's charge of $681 violated Section 12-1009 of CLEC. That section permits a consumer borrower to "prepay a loan in full at any time," and Section

12-1009(e) prohibits the imposition of any prepayment charge "[i]n connection with the prepayment of any loan by a consumer borrower."

The appellate court found a violation of CLEC, reasoning that the $681 charge plainly was a "prepayment charge." Regarding the waiver certificate, the court reasoned that "[f]or this Court to read into § 12-1009(e) an exception, if the amount of the prepayment charge was based upon the amount of permissible closing costs which had earlier been 'waived' or paid by the credit grantor, would be to violate the most basic principle of statutory construction." See *BAA v. Acacia Mutual Life Ins. Co.*, 400 Md. 136, 151, 929 A.2d 1, 10 (2007)("We neither add nor delete words to a clear and unambiguous statute to give it a meaning not reflected by the words the Legislature used, or engage in forced or subtle interpretation in an attempt to … limit the statute's meaning"); *Stoddard v. State*, 395 Md. 653, 668, 911 A.2d 1245, 1254 (2006); *Blake v. State*, 395 Md. 213, 224, 909 A.2d 1020, 1026 (2006).

The court found the proper test to be "whether there is a charge imposed at the time of prepayment that would not be imposed if the note were paid at maturity instead of at an earlier date. Moreover, the nature of such charge, rather than its amount, should be determinative." Indeed, the court noted that other jurisdictions have similarly held. See, e.g., *Goldman v. First Federal Savings and Loan Association*, 518 F.2d 1247 (7th Cir. 1975); *Schmidt v. Interstate Federal Savings & Loan Assoc.*, 421 F. Supp. 1016, 1018 (D.D.C. 1976); *Krause v. GF Capital Mortgage Service, Inc.*, 314 Ill.App.3d 376, 383, 731 N.E.2d 302, 308 (2000).

The court found that the waiver certificate did not permit the Bank to impose an impermissible prepayment charge because Section 12-1023(b)(3) of the Commercial Law Article provides that "[e]xcept as expressly allowed by law, an agreement, note, or other evidence of a loan may not contain a provision by which the borrower waives any right accruing to the borrower under this subtitle." Moreover, Section 12-1023(b)(4) provides that "[a]ny clause or provision in an agreement, note, or other evidence of a loan that is in violation of," *inter alia*, § 12-1023(b)(3) "shall be unenforceable." Hence, the court concluded that the waiver certificate was invalid and unenforceable. Bednar did not waive his right under Section 12-1009(e) to prepay the loan without any prepayment charge.

The court rejected the argument that the closing costs actually were imposed at the time of closing. The settlement statement stated that all closing costs at the time of the closing were paid by the Bank. "Requiring the reimbursement of closing costs that were previously waived and paid by the lender, simply because of the prepayment within three years, is a prepayment charge under the broad language of § 12-1009(e)." The Bank cannot be permitted to circumvent Section 12-1009(e) by calling the charge a "recapturing" of permitted costs. Although the court agreed that there is no time limit on collecting allowable charges, the court reasoned that "collection of such charges may not be dependent upon prepayment."

Finally, with respect to the Bank's reliance upon letters from the Office of the Maryland Commissioner of Financial Regulation, the court acknowledged that ordinarily an administrative agency's interpretation of the statute which the agency administers should be given considerable weight. See *Board of Physician Quality Assurance v. Banks*, 354 Md. 59, 69, 729 A.2d 376, 381 (1999). *MVA v. Shepard*, 399 Md. 241, 252, 923 A.2d 100, 106 (2007); *Miller v. Comptroller*, 398 Md. 272, 281, 920 A.2d 467, 472 (2007). When the statute is entirely clear and unambiguous, however, administrative construction is not given any weight. See, e.g., *Macke Co. v. Comptroller*, 302 Md. 18, 22-23, 485 A.2d 254, 256, 257 (1984); *Maryland Aviation Administration v. Noland*, 386 Md. 556, 572, 873 A.2d 1145, 1155 (2005); *Maryland Division of Labor and Industry v. Triangle General Contractors*, 366 Md. 407, 417, 784 A.2d 534, 539 (2001); *Marriot Employees Federal Credit Union Motor Vehicle Administration*, 346 Md. 437, 446, 697 A.2d 455, 459 (1977).

North Carolina Court Dismisses Claims of Member of Limited Liability Company Against Lender for Lack of Standing

A North Carolina trial court dismissed breach of fiduciary duty and all other claims brought by a member of a limited liability company against a lender for lack of standing, but refused to dismiss the claim for aiding and abetting a breach of fiduciary duty as not stating a claim because of ambiguity as to the existence of such a cause of action under North Carolina law. The court reasoned that neither a shareholder nor a member of a limited liability company has standing to sue for injuries allegedly inflicted upon the company by its lender that result in a diminution of the shareholder or member's equity interest. Because the court questioned whether the tort of aiding and abetting a breach of fiduciary duty exists under North Carolina law, and given the liberal standard to be applied to motions to dismiss, the court refused to dismiss the aiding and abetting claim except on grounds of lack of standing. *Regions Bank v. Regional Property Development Corporation*, 2008 NCBC 8 (Apr. 21, 2008).

Facts. On May 24, 2002, Regions Bank (the "Bank") loaned $745,000 to Lancaster Industrial Park, LLC ("Lancaster") for a real estate development project. Lancaster executed a promissory note pursuant to which it agreed to pay monthly interest and repay the principal balance no later than May 24, 2004. On May 24, 2004, Lancaster executed a second promissory note that extended the loan amount and provided that the loan would be repaid in 12 months.

On May 24, 2005, the loan remained unpaid and Lancaster received an extension of the maturity date through November 24, 2005. It failed to pay off the loan by the extended maturity date and, unbeknownst to Lancaster, the Bank began negotiating with three individual member/managers of Lancaster regarding the sale and assignment of the loan. On February 23, 2006, the Bank sold the loan to the individual members.

Litigation. On May 24, 2007, Regional Property Development Corporation ("Regional"), one of four member/managers of Lancaster, filed a demand for arbitration against the Bank. It asserted claims for breach of contract, breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, breach of the duty of good faith, and unfair and deceptive trade practices arising from the sale of the loan.

On June 22, 2007, the Bank filed a state court complaint and moved to stay the arbitration proceeding. The Bank sought a declaratory judgment that, as to the loan transaction, (i) the Bank and Regional had no contractual relationship, (ii) the Bank owed Regional no fiduciary duty, (iii) the Bank did not aid and abet any breach of fiduciary duty, (iv) the Bank owed no duty of good faith to Regional, and (v) the Bank did not engage in any unfair or deceptive trade practices.

Regional filed a counterclaim alleging that the Bank aided and abetted a breach of fiduciary duty. On December 7, 2007, the Bank moved to dismiss the counterclaim. It also filed a third-party complaint against Lawrence and Michael Shaheen for indemnity as to the counterclaim and other related lawsuits.

On December 10, 2007, the Bank filed an amended motion to dismiss the counterclaim, and Regional filed a response on January 11, 2008. An amended counterclaim was filed on March 3, 3008, which was followed on March 13, 2008 by a motion to dismiss filed by the Bank. The amended counterclaim alleged that Mark Carpenter, one of the individual members who bought the loan, breached a fiduciary duty owed Lancaster by acquiring the loan without providing notice to Lancaster or Regional, and that the Bank aided and abetted such breach by purposely failing to provide Lancaster with notice either of the loan's default or of its transfer to Carpenter.

Regional contended that the Bank was not authorized to sell the loan to individual members and that the individual members who bought the loan (not defendants) had a duty to notify Regional of their intent to acquire the loan so that it could either refinance it or pay it off.

Regional further contended that the Bank had established a practice of allowing principal to be drawn down to pay accrued interest until "a payoff solution could be devised" and that, despite this practice, the Bank sold the loan to the individual members with knowledge that they intended to use Lancaster's alleged default as leverage to force Regional to agree to a modification of the operating agreement which would diminish the value of Regional's equity interest in Lancaster. Regional asserted that the individual members used the threat of default and foreclosure to force Regional to agree to over $600,000 in distributions from Lancaster to the individual members.

The Bank contended that North Carolina law does not recognize a claim for aiding and abetting a breach of fiduciary duty under the facts of the case and that no authority exists for permitting an individual member of a limited liability company to assert a claim for selling a loan which was in default. Regional contended that North Carolina courts have not foreclosed such a claim.

The Bank further contended that Regional failed to allege an injury to itself that was "separate and distinct" from that suffered by Lancaster or the other member managers, or that the injury arises out of a special duty owed Regional by the Bank. Absent such allegations, the Bank contended that Regional could not pursue a claim for the diminution in value of its equity interest in Lancaster—a claim characterized as a derivative claim that could only be pursued by Lancaster. Regional responded that it was the only entity harmed by the Bank's actions in aiding and abetting the breach of fiduciary duty and that, therefore, it has alleged a "separate and distinct" injury.

Standing. The court found it to be well-established that "shareholders cannot pursue individual causes of action against third parties for wrongs or injuries to the corporation that result in the diminution nor destruction of the value of their stock." *Barger v. McCoy Hillard & Parks*, 346 N.C. 650, 658, 488 S.E.2d 215, 219 (1997); *Jordan v. Hartness*, 230 N.C. 718, 719, 55 S.E.2d 484, 485 (1949)). Yet:

> [A] shareholder may maintain an individual action against a third party for an injury that directly affects the shareholder, even if the cor-

> poration also has a cause of action arising from the same wrong, if the shareholder can show that the wrongdoer owed him a special duty or that the injury suffered by the shareholder is separate and distinct from the injury sustained by the other shareholders or the corporation itself.

Barger, 346 N.C. at 658, 488 S.E.2d at 219. Hence, the court found two exceptions to the general rule: "where (1) a plaintiff alleges an injury 'separate and distinct' to itself, or (2) the injuries arise out of a 'special duty' running from the alleged wrongdoer to the plaintiff."

These principles were found to apply equally to suits filed by members of a limited liability company. See *Dawson v. Atlanta Design Assocs., Inc.*, 144 N.C. App. 716, 719 n.1, 555 S.E.2d 877, 880 n.1 (2001).

The court noted that Regional did not allege that it held a minority interest in Lancaster and, therefore, the court reasoned that the individual members could not have owed Regional a special duty arising from their control of the company. See *Outen v. Mical*, 118 N.C. App. 263, 266, 454 S.E.2d 883, 886 (1995); *Fulton v. Talbert*, 255 N.C. 183, 185, 120 S.E.2d 410, 412 (1961). Although the court recognized that Regional alleged that the individual members leveraged their control over the loan to force Regional to agree to allow Lancaster to make $600,000 in distributions to the individual members that otherwise were not due them, the court found that this was just another way of saying that the individual member wrongfully diverted company assets. "By any measure, the right to pursue such a claim belongs to the Company, not its members" because of the need to protect the rights of possible creditors. Because the court found that Regional sought to assert a right properly belonging to Lancaster, it dismissed its claims.

▸ **LENDER'S AIDING AND ABETTING A BREACH OF FIDUCIARY DUTY**. The court refused to dismiss Regional's claim against the Bank for aiding and abetting a breach of fiduciary duty for failure to state a claim, as opposed to lack of standing. The court previously had questioned whether North Carolina law recognizes a claim for aiding and abetting a breach of fiduciary duty. See *Battleground Veterinary Hosp., P.C. v. McGeough*, 2007 NCBC 33 (Super. Ct. Oct. 19, 2007). The court reasoned that there was doubt because the sole North Carolina appellate decision to have recognized such a claim involved allegations of securities fraud and the federal claim was subsequently overruled by the United States Supreme Court. *Compare Sompo Japan Ins. Co. v. Deloitte & Touche, LLP*, 2005 NCBC 2 (Super. Ct. June 10, 2005)(discussing *Blow v. Shaughnessy*, 88 N.C. App. 484, 364 S.E.2d 444 (1988) and *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994)), with *Equitable Life Assurance Soc'y of the U.S. v. Am. Bankers Ins. Co. of Fla.*, 1995 U.S. Dist. LEXIS 10880 at *34 (E.D.N.C. May 12, 1995) (stating that North Carolina would still recognize such a claim based solely on tort principles), and *In re Lee Memory Gardens, Inc.*, 333 B.R. 76, 80 (Bankr. M.D.N.C. 2005)(stating that North Carolina recognizes such a claim, citing *Blow v. Shaughnessy* for the proposition).

Despite doubt as to whether North Carolina recognizes a claim for aiding and abetting a breach of fiduciary duty, the court refused to dismiss Regional's claim on this basis "[b]ecause there is no binding precedent directly on point, and some persuasive authority suggesting that a common law claim for aiding and abetting breach of fiduciary duty still exists in North Carolina." See also *Sunamerica Fin. Corp. v. Bonham*, 328 N.C. 254, 257, 400 S.E.2d 435, 437 (1991)(indulgent standard to be applied to claim when faced with motion to dismiss).

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