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Legal Briefs from the Attorneys of  
Mackall, Crouse & Moore, PLC

### Creditors' Corner

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#### LENDER LIABILITY FOR CLEAN WATER COMPLIANCE

Prudent lenders conduct due diligence prior to foreclosure to ensure that they are not facing environmental liabilities and permitting problems. In many instances any problems that arose were solved due to the ability to sell the property quickly and the enactment of federal legislation that protected lenders from environmental liabilities. Unfortunately, many lenders are now finding that they are required to hold on to foreclosed properties for many months and years and thus they are faced with a greater risk for successor environmental liability.

There are still lender protections available in the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") and the Resource Conservation and Recovery Act ("RCRA") but it is important to note that those lender protections are noticeably absent from the Clean Water Act ("CWA") and the National Pollutant Discharge Elimination System ("NPDES"). The latter is particularly a concern as it relates to construction projects. It is unlawful to discharge a pollutant, including stormwater, under the CWA without obtaining a permit under NPDES.

Upon a foreclosure, the EPA and state agencies look to the foreclosing lender as the new owner or operator of the incomplete construction site. As a result the lender has to obtain a stormwater discharge permit. State agencies in Georgia, California and Minnesota have already warned foreclosing lenders that they may be liable for permit noncompliance and environmental damages.

**Practice Pointer:** Lenders should conduct extensive due diligence prior to certain foreclosures and work with state agencies or the regional EPA to correct violations or permit issues prior to foreclosure. Attorneys at Mackall, Crouse & Moore, PLC, work regularly with these state and federal agencies in a variety of land use situations and can help guide the foreclosing lender through the regulatory agency thicket and thus avoid unforeseen liability.

## **FRAUD CLAIMS AGAINST BANK UNLOADING BAD LOANS TO NEW LENDERS FAIL BUT AIDING AND ABETTING AND CONSPIRACY CLAIMS SURVIVE SUMMARY JUDGMENT**

The United States District Court for the District of Minnesota confirmed that a lender looking to off-load a bad loan who condones a fraudulent scheme to obtain take-out financing may be liable to the new lenders for aiding and abetting and conspiracy, but that absent particular knowledge unavailable to new lenders, the old lender is still not liable for fraud by omission.

The recent case *American Bank of St. Paul v. TD Bank, N.A.*, involved loans made to former Backstreet Boys and 'N Sync promoter Louis Pearlman, who in addition to developing several prominent "boy band" acts, also ran a massive fraudulent scheme through his aviation company Trans Continental Airlines ("TCA"), which scheme eventually resulted in over \$300 million of losses to investors and lenders. TD Bank, who does business as Mercantile Bank, was a \$28 million lender to Pearlman, secured in part by TCA stock. When Pearlman defaulted on the loan, Mercantile hired NFC Global to investigate Pearlman and TCA's activities. NFC and Mercantile determined: (1) Pearlman's accounting firm, Cohen & Sigel and its principals were not professional licensed anywhere and Cohen & Sigel was not listed in Germany, where it was purportedly headquartered; (2) no aircraft were directly registered to TCA; (3) they could not verify \$145 million cash and cash equivalents claimed by TCA on its financials; and (4) Pearlman's personal financial statement omitted a \$35.5 million in liabilities of which Mercantile had knowledge.

When Mercantile confronted Pearlman, he indicated he could not immediately repay the loans without it getting "very messy" and opening a "can of worms." Mercantile and Pearlman therefore agreed on a forbearance agreement. In the meantime, Pearlman hired North American Capital Markets to obtain new lenders to take-out the Mercantile loan. The offering materials contained the same representations Mercantile could not verify including: (1) TCA held cash and cash equivalents of \$145 million; and (2) TCA owned eight aircraft. The offering materials included statements from Cohen & Sigel, as accountant, and omitted \$35.5 million in liabilities.

American Bank became lead lender for a group of participants who became new lenders and took-out all but \$2 million of the Mercantile debt. To close the deal, Mercantile therefore agreed to purchase a \$2 million participation interest. Pearlman's scheme later unraveled, and the participant group stands to lose substantial funds. Mercantile's exposure was greatly reduced when the new participants arrived.

American Bank sued Mercantile for fraud, as well as for a number of other torts and breach of contract. The court dismissed all claims except for the aiding and abetting and conspiracy claims, which will proceed to trial. The crux of the court's decision on the fraud claims is that Mercantile had no duty to disclose the negative information it learned. The court held that both lenders were sophisticated parties and there would be no duty to disclose unless one party "had special knowledge of material facts to which the other party does not have access." In other words, was the information acquired by Mercantile "readily ascertainable through ordinary channels" to American Bank? The court answered "yes," because American Bank could have conducted a similar private investigation to the one undertaken by Mercantile that revealed the indicia of fraud.

Mercantile could also not be liable for making affirmative fraudulent statements simply by continuing (albeit in a reduced fashion) with the loan; the mere act of participating was not an endorsement or affirmation by Mercantile of the false statements made by Pearlman in the offering materials.

While not liable under a fraud theory, the court found liability could lie for Mercantile in the theories of aiding and abetting and conspiracy. A person is liable for civil aiding and abetting if: (1) a tort by another causes injury to the plaintiff; (2) the defendant has actual knowledge that the tortfeasor's conduct causes a breach of duty; and (3) the defendant substantially assisted in the breach. In this case, the court found that Pearlman had committed fraud and injured American Bank. The court found that the information Mercantile gathered through its investigation suggests that it had actual knowledge of Pearlman's fraud in the offering materials, and that Mercantile's release of the TCA stock and purchase of the \$2 million participation suggests that it substantially assisted in Pearlman's fraud against American Bank. Further, the evidence suggested that the parties could have engaged in civil conspiracy to place the bad loans with American Bank and its participants in that Pearlman and Mercantile had a "meeting of the minds," which only requires a "common understanding" and not an "express or implied agreement." These issues would be resolved at trial.

**Practice Pointer:** The court's ruling on the fraud counts is consistent with a large body of case law which generally precludes such claims between lenders unless there is particular knowledge that the defendant had which the plaintiff could not obtain. Many of these cases involve fraud claims by participant lenders against a lead lender. The attorneys at Mackall, Crouse & Moore, PLC, have represented participants in a number of these types of cases, and can develop strategies to mitigate the presumptive standards that are typically unfavorable to participants. As noted in this case, other torts, such as aiding and abetting, are additional tools for those parties who have been wronged in a commercial transaction, which theories have been relied upon recently during the recent uptick of lender liability claims.

## **PRIVATE EMPLOYERS MAY DISCRIMINATE IN HIRING BASED ON PAST BANKRUPTCY FILING**

The Bankruptcy Code does not prohibit private employers from refusing to hire an individual based on his or her prior bankruptcy filing. That was the holding of the Eleventh Circuit Court of Appeals in its May 17, 2011, decision in *Myers v. TooJay's Management Corporation*, affirming the dismissal of Eric Myers' claim for discrimination in violation of Section 525(b) of the Bankruptcy Code.

In July 2008, Myers applied and was interviewed for a management position at TooJay's Gourmet Deli. At the end of the interview, a two-day, paid, on-the-job evaluation of Myers was scheduled for July 31 and August 1. After completing the on-the-job evaluation, Myers gave his two-week's notice to his current employer, expecting to start work at TooJay's on August 18. In the meantime, however, TooJay's had conducted an authorized background check that revealed that Myers had filed a Chapter 7 bankruptcy petition with a bankruptcy court in North Carolina in January 2008. TooJay's rescinded its offer of employment to Myers based on the bankruptcy filing.

In the lawsuit that followed, Myers alleged that TooJay's refusal to hire him because of his bankruptcy filing violated Section 525(b) of the Bankruptcy Code. That provision provides, in pertinent part:

No private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under this title, a debtor or bankrupt under the Bankruptcy Act, or an individual associated with such debtor or bankrupt ....

Section 525(b) does not refer to hiring activities, and in dismissing the claim, the court contrasted Section 525(b) with Section 525(a), which is applicable to governmental entities and expressly provides that a governmental unit may not "deny employment to" an individual based on a bankruptcy filing. Section 525(b) does not include similar "deny employment to" language. The plain language of Section 525 indicates that only government *employers*, not *private* employers, are barred from discriminating in hiring against bankruptcy filers. "Had Congress wanted to cover a private employer's hiring policies and practices in §525(b), it could have done so the same way it covered a governmental unit's hiring policies and practices in §525(a)."

**Practice Pointer:** Although private employers may refuse to hire an individual because of a bankruptcy filing, they may not consider such a filing in making decisions regarding current employees – including decisions as to promotions, demotions, pay, hours, termination, and the like.

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