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GONZAGA UNIVERSITY SCHOOL OF LAW

Does the ECOA Apply to Guarantors?

Scott J. Burnham

A lender might find itself in trouble if it requires the spouse of a credit applicant to guaranty the debt. The federal Equal Credit Opportunity Act (ECOA) makes it "unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction … on the basis of ... sex or marital status," among other things. **15 U.S.C. § 1691(a)(1)**. The regulations promulgated by the Federal Reserve include a "spouse-guarantor rule" which prohibits a creditor from requiring a spouse to guarantee a credit instrument:

> Additional parties. If, under a creditor's standards of creditworthiness, the personal liability of an additional party is necessary to support the credit requested, a creditor may request a cosigner, guarantor, endorser, or similar party. The applicant's spouse may serve as an additional party, but the creditor shall not require that the spouse be the additional party.

12 C.F.R. § 202.7(d)(5).

The statute permits only "applicants" to sue for ECOA violations, a right that can lead to both actual and punitive damages. **15 U.S.C. § 1691e**. The statutory definition of "applicant" does not expressly include guarantors. *See* **15 U.S.C. § 1691a(b)**. However, the regulations promulgated by the Federal Reserve and now under the auspices of the Consumer Finance Protection Bureau contain their own definition of "applicant," and that definition allows guarantors to sue for violations of the spouse-guarantor rule:

> Applicant means any person who requests or who has received an extension of credit from a creditor, and includes any person who is or may become contractually liable regarding an extension of credit. For purposes of § 202.7(d), the term includes guarantors, sureties, endorsers, and similar parties.

12 C.F.R. § 202.2(e).

Did the Federal Reserve exceed its rule-making authority when it adopted the spouse-guarantor rule? Two recent cases in which the spouse of a debtor was asked to sign a guarantee indicate that the circuit courts are divided on the issue.

In *RL BB Acquisition, LLC v. Bridgemill Commons Development Group, LLC*, **754 F.3d 380** (6th Cir. 2014), the court applied the two-step analysis required by the Supreme Court in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, **467 U.S. 837** (1984) to determine whether the regulation was within the scope of the statute. Step one asks whether Congress directly addressed the precise question at issue. The court concluded that the statutory definition of "applicant" is ambiguous "because it could be read to include third parties who do not initiate an application for credit." *Id.* at 384-85. The guarantor can be said to apply for credit; and credit is not necessarily given to the applicant. *Id.* at 385.

Furthermore, the court looked at the big picture and noted that the purpose of the ECOA is to prohibit discrimination "with respect to any aspect of a credit transaction." (*Id.*, citing § 1691(a)). It might be noted that this argument involves a bit of bootstrapping because the full quote is that the ECOA prohibits discrimination "against any *applicant*, with respect to any aspect of a credit transaction," and the issue is whether a guarantor is an applicant. *Chevron* step two involves determining whether the regulation fills a gap in the statutory design. Having found that the language was at best ambiguous, it was inevitable that the court would conclude that the regulation stemmed from a permissible construction of the statute. *Id.*

The court noted that while most decisions were in accord, Judge Posner's dicta in *Moran Foods, Inc. v. Mid-Atlantic Market Development Co.*, **476 F.3d 436**,

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441 (7th Cir. 2007), stated that "there is nothing ambiguous about 'applicant' and no way to confuse an applicant with a guarantor." 754 F.3d at 386.

In *Hawkins v. Community Bank of Raymore*, 761 F.3d 937 (8th Cir. 2014), the Eighth Circuit saw it differently, expressly disagreeing with the Sixth Circuit's *Chevron* analysis. The *Hawkins* court found that there was nothing ambiguous about the statutory definition of "applicant." The definition did not include guarantors because "assuming a secondary, contingent liability does not amount to a request for credit." *Id.* at 942. Moreover, looking at the big picture, the court found that the policy behind the ECOA was to protect those who were *excluded* from the lending process, not those who were *included*. *Id.* Therefore, the court concluded under the second *Chevron* step that the Federal Reserve exceeded its rulemaking authority when it included guarantors within the definition of applicants. *Id.*

A petition for certiorari has been filed in *Hawkins*. Until the issue is resolved, attorneys for banks in impacted transactions might want to draft a choice-of-forum clause that would require litigation to occur in federal courts in the Eighth Circuit (or the Seventh Circuit, assuming it follows its dicta in *Moran*).

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Collateralizing What the Debtor Does Not Own

Stephen L. Sepinuck

A typical security agreement for inventory financing might describe the collateral as "all of the debtor's currently owned and after-acquired Inventory" and then incorporate the definition of "inventory" from UCC § 9-102(a)(48). Unfortunately, a recent case shows that this language might not be adequate to encumber all that the secured party intends.

In *In re Salander-O'Reilly Galleries, LLC*, 2014 WL 7389901 (S.D.N.Y. 2014), First Republic Bank loaned $29 million to Salander-O'Reilly Galleries, LLC. The gallery authenticated a security agreement granting the bank a security interest in "assets and rights of the Borrower wherever located, whether now owned or hereafter acquired or arising, . . . all personal and fixture property of every kind and nature including without limitation all goods (including inventory)." Sometime later, the gallery accepted numerous works of art on consignment, including a Botticelli painting entitled *Madonna and Child*.

When the gallery entered bankruptcy, the consignor sought the painting back and the bankruptcy trustee, who had received an assignment of the bank's rights, claimed the painting as part of the collateral. The bankruptcy court ruled for the trustee. That ruling was no doubt based in part on the fact that most consignment transactions fall within the scope of Article 9, *see* §§ 9-102(a)(20), 9-109(a)(4), which treats the consignor's interest in the property consigned as a "security interest," § 1-201(b)(35), the consignor as a "secured party," § 9-102(a)(21), (73)(C), and the consignee as a "debtor," § 9-102(a)(19), (28)(C). More important, Article 9 then declares that, for the purpose of determining the rights of creditors and purchasers, "the consignee is deemed to have rights and title to the goods identical to those the consignor had." § 9-319(a). In other words, the UCC gives a consignee the ability to encumber consigned goods: goods that the consignee does not truly own.

On appeal, the district court reversed. Looking to the language of the security agreement, the district court concluded that the phrase "whether now owned or hereafter acquired or arising" limited the otherwise broad grant of a security interest to only property "*owned* or thereafter *owned*" by the gallery (emphasis in original). Because the gallery did not own the painting, the gallery had not granted a security interest in it.

The court's ruling is in one respect surprising. While the gallery unquestionably never "owned" the painting, it did arguably "acquire" the painting. After

all, the gallery acquired possession and, by virtue of § 9-319(a), acquired the power to transfer the consignor's rights in the painting. Nevertheless, the court characterized as "undisputed" the fact that the Botticelli was never "owned" or "acquired" by the gallery, so perhaps the trustee made a poor tactical concession. In any event, the case illustrates that traditional language in the description of the collateral in a security agreement might be inadequate to encumber consigned goods.

The same problem can arise with respect to accounts and chattel paper. The UCC treats the buyer of such property as a secured party, the buyer's rights as a security interest, and the seller as a debtor. *See* §§ 1-201(b)(35), 9-102(a)(28)(B), (73)(D). It also provides that if a buyer fails to perfect its security interest, the seller/debtor has the power to transfer the buyer's rights. § 9-318(b). In short, a seller of accounts or chattel paper occasionally has the power to encumber property that the seller does not own. An agreement purporting to grant a security interest in all accounts and chattel paper that the debtor "owns or hereafter acquires" would not, under the reasoning of *Salander-O'Reilly Galleries*, be sufficient to encumber any such receivables that the debtor previously sold to a buyer who failed to perfect.

No doubt there are many ways for transactional lawyers to avoid this problem. Here are two examples that should work:

All of Borrower's currently owned and hereafter-acquired Inventory together with all goods currently or hereafter consigned to Borrower.

All of Borrower's existing and after-acquired accounts and chattel paper together with all accounts and chattel paper in which Borrower is deemed by law to have rights or the power to convey rights.

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Recent Cases

SECURED TRANSACTIONS

Attachment Issues

In re Gracy,
2015 WL 132925 (Bankr. D. Kan. 2015)
Mortgage that purported to encumber "fixtures" on the real estate did not create a security interest in the debtor's mobile home – even if the mobile home was a fixture – because under § 9-108(e)(2) a description of collateral only by type is inadequate for consumer goods in a consumer transaction.

Matter of Liquidation of Freestone Insurance Co.,
2014 WL 7399502 (Del. Ch. Ct. 2014)
Bank could not retain the assets credited to the custodial account of an insurance company, now in receivership, to protect the bank's contingent right to indemnification because that right was not secured by the collateral. The custody agreement granted the bank a security interest to secure "payment obligations," which, when the agreement is read in context, means (i) costs incurred by the bank in providing the limited administrative services contemplated by the agreement, (ii) fees charged for those services, (iii) advances of funds by the bank to make payment on or against delivery of securities, and (iv) overdrafts in the account; the term "payment obligations" does not include claims for indemnification.

Enforcement Issues

Dalton v. Santander Consumer USA, Inc.,
2014 WL 7463867 (N.M. Ct. App. 2014)
Subprime automobile finance contracts that generally required arbitration of all claims but permitted the secured party to exercise self-help remedies and permitted either party to bring an action in small claims court was unconscionable because it has the practical effect of preserving the secured party's ability to pursue in court its most important claims while severely limiting the debtor's access to judicial redress for the debtor's most likely claims – fraud, misrepresentation, and tortious debt collection – which are likely to fall outside the jurisdictional limits of small claims courts.

In re Brican America LLC Equipment Lease Litigation, **2015 WL 235409** (S.D. Fla. 2015)

Buyer of equipment leases was not a holder in due course, and therefore took subject to the fraud defenses of the lessees, because: (i) the originator intended to defraud the lessees; (ii) the buyer knew that the originator was marketing the lease transactions as "risk free" and promising to buy back the leases if the advertiser stopped making the payments that were supposed to offset the rent due; and (iii) as the buyer learned more about the originator's promises, it responded not with caution but by increasing its financing ten-fold.

Vulcan Capital Corp. v. Miller Energy Resources, Inc., **2015 WL 293839** (N.D. Tex. 2015)

Debtor stated sufficient facts to raise a defense of duress with respect to a pledge agreement, pursuant to which the debtor provided replacement collateral for an outstanding indebtedness, by alleging that the creditor threatened to have the debtor's owner arrested and prosecuted if the debtor refused to sign the pledge agreement. The debtor failed to raise a defense based on fraud or breach of contract by claiming that the creditor promised not to go after the collateral and failed to provide promised financing because the pledge agreement contained a merger clause and thus evidence of any such promises was inadmissible.

Liability Issues

BancorpSouth Bank v. 51 Concrete, LLC, **2015 WL 340364** (Tenn. Ct. App. 2012)

Secured party that brought a conversion claim against the buyers of the debtor's equipment for failing to turn over the proceeds they received upon resale did not have a right to attorney's fees under § 9-607(d) because that provision merely allows a secured party to deduct attorney's fees from any collections made, it does not provide for attorney's fees in addition to other damages. The secured party was also not entitled to attorney's fees pursuant to the security agreement with the original debtor, even though that agreement became effective against the buyers under § 9-201(a), because the agreement stated merely that the secured party could "apply the proceeds of any collection or disposition first to . . . reasonable attorney's fees," and this case did not involve any collection or disposition.

Gregoria v. Total Asset Recovery, Inc., **2015 WL 115501** (E.D. Pa. 2015)

Repossession agent could be liable under RICO – but not under the Fair Debt Collection Practices Act – for repossessing a car after default because the 150% interest rate on the secured obligation was usurious under Pennsylvania law. Even though the security agreement provided that it was governed by Delaware law – which has no prohibition on usury – Pennsylvania law governed because the car was brought into the state, the litigation occurred there, and Pennsylvania's restrictions on usury are fundamental policy of the state.

BANKRUPTCY

In re Genmar Holdings, Inc., **2015 WL 350721** (8th Cir. 2015)

Because the settlement agreement between the buyer and seller of a defective boat required the seller to refund the buyer's down payment "no sooner tha[n] 15 days" after the buyer re-conveyed title and the seller received confirmation that the buyer's lender had discharged its lien, it was not clear that the exchange was intended to be contemporaneous, and thus the buyer was not entitled to a contemporaneous exchange preference defense under § 547(c)(1). While providing a reasonable time for review of the title documents would not be inconsistent with a contemporaneous exchange, the settlement agreement's provision for a *mandatory* delay more closely resembled a short-term loan.

LENDING & CONTRACTING

Clemmer v. Columbia Group, Inc.,
2014 WL 7429436 (W.D. Okla. 2014)
Junior creditor remained subject to subordination agreement even though the senior debt was acquired by an entity apparently related to the debtor in part because the subordination agreement granted the senior creditor the right to exchange, sell, or surrender its security interest without impairing or affecting the agreement.

U.S. Bank v. Grayson Hospitality, Inc.,
2014 WL 7272842 (E.D. Tex. 2014)
Secured lender was not entitled to the appointment of a receiver for hotel properties owned by the debtors despite a clause in the mortgages providing for a receiver upon default because the lender could use – indeed, had twice begun but abandoned – the "less drastic" remedy of foreclosure.

In re NMFC, LLC,
2015 WL 154741 (D.S.C. 2015)
Because the patent assignment that an individual inventor provided to his employer covered "all divisions, and continuations thereof," the entity that purchased the patent from the employer's secured party at a disposition acquired the subsequent continuation-in-part. The language of the assignment was unambiguous; the original inventor did not retain – and therefore could not transfer – any interest in a continuation-in-part.

Asphalt Paving Sys., Inc. v. Gen. Combustion Corp.,
2015 WL 167378 (D.N.J. 2015)
The use of the word "shall" in a forum-selection clause providing that "jurisdiction of any dispute shall be in Orange County, Florida" was sufficient to indicate that the clause was exclusive and mandatory, not merely permissive.

MeehanCombs Global Credit Opp. Funds v. Caesars Ent. Corp., **2015 WL 221055** (S.D.N.Y. 2015)
Bondholders stated a cause of action for violation of the Trust Indenture Act by alleging that the issuance of a new indenture, without the bondholder's consent, eliminated a parent guarantee, leaving the bondholders to collect from an insolvent issuer.

Sikorsky Financial Credit Union, Inc. v. Butts,
2015 WL 340662 (Conn. 2015)
A creditor's right to post-maturity interest does not terminate upon entry of a judgment. However, because the parties' agreement did not enumerate a specific post-maturity interest rate but, instead used the phrase "highest lawful rate," a secured party who obtained a deficiency judgment was entitled to post-maturity interest at the legal rate.

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Follow the link below for a detailed list of

2014 Commercial Law Developments

The file synopsizes more than 400 judicial decisions

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