

Credit Union Attorney Law Letter

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C Bank Receives Only Partial Coverage for Loan Losses And Insurer Receives Subrogation

In *BancInsure, Inc. v. BNC National Bank, N.A.*, No. 00-2118 (8th Cir. Aug. 16, 2001), the Eighth Circuit affirmed a ruling that an insurance company was not obligated to pay for approximately \$400,000 in losses that a bank incurred because of the wrongful conduct of a loan officer. Moreover, the insurance company was entitled to a portion of settlement proceeds obtained from the former loan officer as subrogation for the sum it did have to pay.

Nature of the Bad Loans

BNC National Bank, N.A., employed Debra J. Gronlie as a senior vice president. From 1995 to 1997, Gronlie made loans to a company owned by Tom Harper, called “Top Dog Productions.” Top Dog distributed and managed motion simulator video games.

In particular, Gronlie made two loans to Top Dog that she represented to Bank officers would be used solely to reduce Top Dog’s outstanding line of credit. Thereafter,

Gronlie personally approved release of \$181,500 in loan proceeds to Top Dog so that it could obtain a motion simulator and sell it to a company called “Alamation.” Gronlie’s husband and Harper owned Alamation.

In 1997, Harper and Top Dog defaulted on their loans and the Bank fired Gronlie. She and her husband later purchased Harper’s interest in Alamation.

Insurance to Cover Losses

The Bank had a financial institution bond issued by BancInsure, Inc., a captive company for state bankers associations that provides insurance coverage for various banks. The bond provided fidelity coverage for losses resulting “from dishonest or fraudulent acts committed by an Employee acting alone or in collusion with others,” if the acts were committed with the manifest intent “(a) to cause the [Bank] to sustain such loss; and (b) to obtain financial benefit for the Employee or other person or entity.” The clause further stated that, “if some or all of the Insured’s loss result[ed] directly or indirectly from Loans, that portion of the loss [was] not covered unless the Employee was in collusion with one or more parties to the transactions and ... received, in connection therewith, a financial benefit with a value of at least

\$2,500.”

The Bank submitted a proof of loss on the Top Dog loans to BancInsure. Subject to a full reservation of rights, BancInsure issued checks covering the Bank’s losses on the loans to Harper and Top Dog, a total of just over \$886,000. \$300,000 of that amount was later attributed to coverage under a provision of the bond other than the fidelity provision quoted above.

Declaratory Judgment Action

After paying out insurance proceeds, BancInsure filed a declaratory judgment action in a federal district court, seeking a determination of its obligation under the fidelity provision of the bond.

Following a trial, a federal district court ruled that only two of the loans Gronlie made to Harper and Top Dog were made “with the manifest intent ... to cause the Insured to sustain [a] loss; and ... to obtain financial benefit for [Gronlie] or [another].” The two loans were those Gronlie had represented would be used to reduce Top Dog’s line of credit and which she later allowed Top Dog to use in connection with Alamation’s purchase of a motion simulator. The losses covered under the fidelity provision totaled \$181,500.

Settlement with Gronlie

While the Bank and BancInsure were battling over which losses were covered, the U.S. Department of Treasury, Comptroller of Currency, commenced administrative proceedings against Gronlie seeking various debarments. This proceeding culminated in a settlement. Under its terms, Gronlie agreed to pay the Bank “and/or” BancInsure \$473,000 in installments and to sign a \$100,000 personal guaranty.

Subrogation

After signing this settlement, BancInsure asked the federal district court to determine its subrogation rights, i.e., whether it was entitled to recoup from Gronlie’s settlement payments the \$181,500 the court had ruled it owed the Bank under the fidelity provision of the bond. The court awarded BancInsure subrogation, less expenses the Bank had incurred to induce Gronlie’s

settlement.

Appeal

The Bank appealed these rulings. On appeal, the Eighth Circuit affirmed all of the district court’s decisions regarding coverage and subrogation rights.

C Independent Contractor is Part of Traditional ERISA Relationship and ERISA “Beneficiary” Includes Person Whose Services Accrued Benefit

In *Hollis v. Provident Life & Accident Insur. Co.*, No. 99-60877 (5th Cir. Aug. 8, 2001), the Fifth Circuit held that an independent contractor was in a traditional ERISA relationship and rejected his argument that the term “beneficiary” under the Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001 *et seq.* (“ERISA”), does not include those persons whose employment services accrued the benefit.

Facts

In 1970, Larry Hollis began working for R.M. Hendrick Graduate Supply House, Inc. (“Graduate Supply”), as a salesman. Beginning in 1981, Hollis’s employment status changed from employee to independent contractor, but his work remained the same.

Graduate Supply had an ERISA-covered program for providing life, medical, and disability benefits to its employees. Hollis participated, even after he became an independent contractor. Pursuant to this program, Hollis procured disability insurance from Provident Life and Accident Insurance Company. Graduate Supply paid \$600 annually toward policy premiums.

In 1995, a physician diagnosed Hollis with advanced degenerative disc disease. He resigned from Graduate Supply because of this problem. He then submitted a disability claim to Provident and it began paying benefits.

In early 1997, Provident reviewed Hollis’s case and terminated his benefits on the ground that he was not

“totally” disabled, as his disability policy required.

After losing his disability benefits, Hollis sued Provident in a Mississippi state court, alleging state-law claims of breach of contract and bad faith denial of insurance benefits. Provident had the case moved to a federal district court and then asked for a judgment before trial on the theory ERISA prevented Hollis from asserting any state-law claims.

ERISA Preemption Question

ERISA bars state-law claims when: (1) they address “areas of exclusive federal concern, such as the right to receive benefits under the terms of an ERISA plan; and (2) [they] directly affect the relationship between the traditional ERISA entities--the employer, the plan and its fiduciaries, and the participants and beneficiaries.” *Citing* 29 U.S.C. § 1144(a). A beneficiary’s remedy for violations of ERISA is an administrative proceeding where rights are determined by a designated ERISA plan administrator.

Because Hollis’s Provident disability policy was purchased under Graduate Supply’s ERISA plan, Hollis’s state-law claims clearly addressed areas of exclusive federal concern. The preemption question therefore turned on whether Hollis’s state-law claims directly affected a relationship between traditional ERISA entities. Hollis argued they did not because he was an independent contractor and because he, as the person whose service accrued the benefits, was not a “beneficiary” within the meaning of ERISA, *see Darden v. Nationwide Mutual Ins. Co.*, 796 F.2d 701, 704 n.3 (4th Cir. 1986).

The district court agreed with Hollis’s argument that, because he was an independent contractor, his state-law claims did not affect a relationship between traditional ERISA entities. The district court did not reach Hollis’s argument that he was not a beneficiary.

The district court allowed Hollis to present his case to a jury. The jury found Hollis to be totally disabled within the meaning of Provident’s policy and awarded him benefits and damages. Provident appealed.

Appeal

On appeal, the Fifth Circuit reversed. It rejected the conclusion that because Hollis was an independent contractor his claims did not affect a traditional ERISA relationship. It then addressed and rejected Hollis’s argument that, as the person whose services accrued the benefit, Hollis was not a beneficiary within the meaning of ERISA. Citing cases from the Third, Eighth, Ninth, and Eleventh Circuits, the Fifth Circuit held that “ERISA’s definition of beneficiary means precisely what it says[;] a beneficiary is a person designated by a participant or by the terms of an employee benefit plan, who is or may be entitled to a benefit thereunder.” Hollis was designated as a beneficiary by the terms of Graduate Supply’s plan and therefore was an ERISA beneficiary. Accordingly, Hollis had to exhaust the administrative remedies provided by ERISA.

C Creditor’s Right to Withdraw from Involuntary Bankruptcy Petition; Definition of “Bona Fide Dispute”; and Clear Error Standard of Review For Deciding If Claim Is Subject to Bona Fide Dispute

In *In re Vortex Fishing Systems, Inc. (Liberty Tool & Manufacturing v. Vortex Fishing Systems, Inc.)*, no. 00-15259 (9th Cir. Aug. 28, 2001), the Ninth Circuit provided guidance on when a creditor may withdraw from a petition seeking to place a debtor in involuntary bankruptcy. It also adopted an objective definition for the term “bona fide dispute” in the statute authorizing involuntary bankruptcy petitions. At the same time, it adopted a clear error standard for reviewing a bankruptcy court’s ruling on whether a claim is subject to a bona fide dispute.

Involuntary Bankruptcy Petition

Under 11 U.S.C. §§ 104 and 303(b)(1), three or more creditors of a debtor who has 12 or more creditors can petition to place the debtor in involuntary bankruptcy if the three creditors have claims not subject to a bona fide dispute and their claims aggregate at least \$10,775.

In this case, a minority shareholder of Vortex Fishing Systems, Inc. (“Vortex”) teamed with a party interested in purchasing Vortex and encouraged several creditors of Vortex to petition to place it in involuntary bankruptcy. In all, seven creditors petitioned.

One of the initial petitioning creditors, Byron-Lambert asked to be dismissed soon after filing because it had misunderstood the nature of the proceedings. The bankruptcy court granted its dismissal request.

After a hearing, the bankruptcy court found that, with respect to the claims of three creditors, Vortex’s debts were the subject of bona fide disputes. The bankruptcy court did not address the rights of the remaining creditors to petition, presumably because their claims in the aggregate did not total \$10,775.

The creditors appealed to the Ninth Circuit.

Dismissal of a Creditor’s Petition

The appeals court first reviewed the decision to dismiss Byron-Lambert, the creditor who asserted that it had misunderstood the nature of the proceeding. The other petitioners objected to Byron-Lambert’s dismissal, arguing that it was the equivalent of dismissing a creditor whom the debtor has paid off to avoid the involuntary petition. The Ninth Circuit has long recognized a rule that “subsequent payment by a bankrupt of some of [the] creditors [cannot] deprive the court of jurisdiction.” *Reed v. Thornton*, 43 F.2d 813, 813 (9th Cir. 1930). The appeals court saw no evidence of a pay-off in this case though.

Alternatively, still objecting to Byron-Lambert’s dismissal, the other creditors pointed to a bankruptcy case in which a creditor was not allowed to withdraw its petition, even on the ground of misunderstanding, because, withdrawal would have left an insufficient number of petitioning creditors. *See In re Molen Drilling Co.*, 68 B.R. 840 (Bankr. D. Mont. 1987). The Ninth Circuit distinguished *In re Molen* on the ground that, at

the time Byron-Lambert sought to withdraw, there were still three petitioning creditors. The Ninth Circuit also refused to require the bankruptcy court to evaluate the claims of the remaining creditors, as subject to bona fide dispute or not, before granting a dismissal.

Definition of “Bona Fide Dispute”

The Ninth Circuit next evaluated the bankruptcy court’s ruling that three creditors’s claims were the subject of bona fide disputes. Because the court had not previously reviewed a ruling that a dispute was bona fide, it first took this opportunity to define a “bona fide dispute,” adopting an objective definition, used by a majority of circuits, over a subjective one. The objective definition--often referred to as *Busick’s* objective test--requires a bankruptcy court to “determine whether there is an objective basis for either a factual or legal dispute as to the validity of the debt.” *In re Busick*, 831 F.2d 745, 750 (7th Cir. 1987). The subjective determination, rejected by the court, requires a determination of whether a debt was made in good faith.

Here, the bankruptcy court had used the objective definition of “bona fide dispute” during the hearing on the involuntary petition, so the appeals court did not have to reject any of the bankruptcy court’s rulings on the basis of the definition it had used.

Standard of Review

Next, the Ninth Circuit had to decide what standard to use when reviewing a bankruptcy court’s decision about whether a creditor’s claim is subject to a bona fide dispute. The court selected the very deferential clear error standard of review. Under it, a ruling is affirmed if there is any evidence to support it.

Here, the Ninth Circuit found support for the bankruptcy court’s belief that the claims of three creditors were the subject of bona fide disputes.

Because the claims of the remaining petitioning creditors did not amount to at least \$10,775, the court affirmed

dismissal of the involuntary petition.

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