

Credit Union Attorney Law Letter

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Cases Reported

Lender Who Failed to Intervene for Borrower When Letter of Credit Was Dishonored Lost Right to Enforce SBA Agreement Guaranteeing Loan, <i>First Tennessee National Bank Association v. Barreto, as Administrator of the Small Business Administration</i>,	1
Bank Not Liable Under ERISA For Losses Beneficiary Suffered When Bank Failed to Transfer Assets to Higher Performing Mutual Funds, <i>Helfrich v. PNC Bank, Kentucky, Inc.</i>,	4
Section 731 of the Gramm-Leach-Bliley Financial Modernization Act of 1999 Is Constitutional, <i>Johnson v. Bank of Bentonville</i>,	3

Lender Who Failed to Intervene for Borrower When Letter of Credit Was Dishonored Lost Right to Enforce SBA Agreement Guaranteeing Loan

In *First Tennessee National Bank Association v. Barreto, as Administrator of the Small Business Administration*, No. 98-6020 (6th Cir. Oct. 9, 2001), the Sixth Circuit refused to compel the Small Business Administration (“SBA”) to honor a guaranty agreement by repurchasing a defaulted loan. The reason: First Tennessee National Bank Association (“First Tennessee”), the lender, took no steps to encourage another bank to honor a letter of credit presented by the borrower. The court held that First Tennessee’s inaction was inconsistent with prudent banking practices and therefore a material breach of its guaranty agreement with the SBA.

Facts

In June 1990, First Tennessee applied to the SBA to guarantee a revolving line of credit loan to Telware International, Inc., an export company. The SBA eventually approved First Tennessee’s request and issued a loan authorization, agreeing to guarantee eighty-five percent of the revolving line of credit.

The guaranty agreement expressly obligated First Tennessee “to close and disburse all SBA-guaranteed loans in accordance with the terms and conditions of the applicable loan authorization, and to take all actions, consistent with prudent closing practices, necessary to protect the interests of the SBA.” It also obligated First Tennessee to follow the loan servicing standards employed by prudent lenders generally” and incorporated all of the SBA’s rules and regulations.

In December 1990, Telware agreed to sell 2,000 metric tons of beans to Centrocoop, a Yugoslavian food distributor. Beogradska Banka, a Yugoslavian bank, provided Telware with a letter of credit to secure Centrocoop’s payment for the beans. Pursuant to the loan authorization, First Tennessee advanced funds to Telware that enabled the company to purchase the beans

for resale to Centrocoop. Telware then assigned First Tennessee its interest in the proceeds of the letter of credit.

After purchasing the beans, Telware assembled the documentation required under the letter of credit and presented it to Beogradska Banka for payment. Beogradska Banka rejected Telware's documentation, claiming that certain bills of lading were endorsed incorrectly. Telware contacted its loan officer at First Tennessee and told him of the problem. Although he expressed concern, he took no action of any kind and promptly departed on a scheduled vacation. Telware presented the letter of credit to Beogradska Banka a second time and it was again rejected. This time Telware learned that Centrocoop had complaints about some of its past bean shipments.

After Beogradska Banka dishonored Telware's second presentment, Telware had to sell its beans for significantly less than Centrocoop had originally offered. Telware later defaulted on its loan.

In June 1992, First Tennessee asked the SBA to repurchase eighty-five percent of the outstanding principal balance of Telware's defaulted loan. The SBA refused, contending that First Tennessee was not entitled to enforce the guaranty agreement because it had not prudently handled Telware's loan. First Tennessee filed suit in a federal district court, seeking to force the SBA to honor the guaranty agreement.

Burden of Proof

As stated above, First Tennessee's guaranty agreement expressly incorporated the SBA's regulations. Under those regulations, the SBA is relieved of any obligation to purchase its share of a guaranteed loan, "unless the Lender has substantially complied with all of the provisions of the[] regulations, the Guaranty Agreement, and the Loan Authorization." 13 C.F.R. § 120.202-5. Pointing to this regulation, the SBA argued that, to be entitled to enforcement of the guaranty agreement, First Tennessee had to prove that it had substantially complied with the terms of the agreement. First Tennessee disagreed, arguing that the SBA had the

burden of proving First Tennessee's lack of substantial compliance. The district court agreed with the SBA that First Tennessee had the burden of proof.

First Tennessee's Obligations Under the Guaranty Agreement

During a trial on the enforceability of the guaranty agreement, the SBA argued that First Tennessee had not behaved prudently in its handling of Beogradska Banka's refusal to honor Telware's first presentment of the letter of credit. Specifically, the SBA maintained, First Tennessee's conduct violated SBA standard operating procedure ("SOP") 50-10-2, which was incorporated into the agreement by reference. SOP 50-10-2 states: "It is anticipated that the lender's commercial loan officer will work with its international department (or with the international division of its correspondent) in the implementation of an [export revolving line of credit]. The complexities of export finance warrant the services of banking experts in this field."

At trial, the SBA showed that the First Tennessee loan officer in charge of Telware's loan never involved the international department in Beogradska Banka's refusal to honor Telware's first presentment. The SBA also presented a banking expert who testified about several steps that First Tennessee could have taken that might have persuaded Beogradska Banka to honor the letter of credit.

After a trial, the federal district court concluded that, by failing to intervene to try to convince Beogradska Banka to honor Telware's letter of credit, First Tennessee had violated its obligation to service Telware's loan in a commercially reasonable manner. The court concluded that the mere fact that First Tennessee's intervention *may have* resulted in a different outcome meant that First Tennessee had materially breached the terms of the guaranty agreement. Therefore, the court refused to force the SBA to take responsibility for any part of the loan.

First Tennessee appealed the trial court's ruling, but

the Sixth Circuit affirmed it in all respects.

Section 731 of the Gramm-Leach-Bliley Financial Modernization Act of 1999 Is Constitutional

In *Johnson v. Bank of Bentonville*, No. 01-1128 (8th Cir. October 4, 2001), the Eighth Circuit upheld the constitutionality of Section 731 of the Gramm-Leach-Bliley Financial Modernization Act of 1999 (“the Financial Modernization Act”), 12 U.S.C. § 1831u(f).

What Section 731 Does

Some states have constitutional provisions limiting interest that state-chartered banks can charge to an amount that is 5 percent above the discount rate for 90-day commercial paper. These interest-rate caps do not apply to national banks or out-of-state banks operating branches within the state. As a result, in some states (until the Financial Modernization Act was passed), national or out-of-state branch banks could charge more interest than the state-chartered banks.

Section 731 was passed to eliminate the differences in interest rates that can be charged by in-state and out-of-state financial institutions operating within a state having a constitutional provision capping interest at 5 percent above the discount rate. Specifically, Section 731 authorizes the in-state banks, upon the establishment in their state of a branch of any out-of-State bank, to increase interest rates to the rates that can be charged by the out-of state bank. *See* 12 U.S.C. § 1831u(f).

Constitutional Challenge

Arkansas is a state with a constitutional provision affected by Section 731. After the passage of the Financial Modernization Act, Steve Johnson (apparently an Arkansas resident) sued in a federal district court, asking the court to declare Section 731 unconstitutional. He asserted two theories: (1) that Section 731 violates the principles of dual sovereignty; and (2) that the Commerce Clause of the U.S. Constitution--the provision

on which Congress relied for its authority to enact Section 731--does not extend Congress such power.

The federal district court rejected Johnson’s arguments and upheld the constitutionality of Section 731. Johnson appealed.

On appeal, the Eighth Circuit affirmed. It gave the following rationale for rejecting Johnson’s arguments:

Dual Sovereignty/Supremacy Clause

With respect to Johnson’s dual sovereignty argument, the court explained:

“[P]ursuant to the power derived from the Supremacy Clause, ‘[a]s long as it is acting within the powers granted it under the Constitution, Congress may impose its will on the States and may legislate in areas traditionally regulated by States.’”

The Court will not, however, conclude that Congress has used its Supreme Clause power to pre-empt state law unless, the language of its legislation makes its intention to pre-empt “unmistakably clear.” Here, the court found, Congress was unmistakably clear in its intention to pre-empt state interest-rate caps.

Commerce Clause

With respect to Johnson’s Commerce Clause argument, the court stated:

“The Commerce Clause permits Congress ‘to regulate those activities having a substantial relation to interstate commerce Prior to the enactment of section 731, banks operating within Arkansas were placed at a competitive disadvantage as compared to national banks because of their inability to charge equivalent interest rates, thereby affecting the flow of currency between Arkansas and other states. It was within Congress’s power under the Commerce Clause to eliminate this disparity by enacting section 731.’”

Bank Not Liable Under ERISA For Losses Beneficiary Suffered When Bank Failed to Transfer Assets to Higher Performing Mutual Funds

In *Helfrich v. PNC Bank, Kentucky, Inc.*, No. 00-5148 (6th Cir. Oct. 1, 2001), the Sixth Circuit has refused to allow a beneficiary/employee to recover money from a bank that administered his employer's 401(k)(1) profit sharing plan, even though the bank undisputedly failed to roll over \$700,000 in equity funds in accordance with a proper request.

Facts

Kenneth G. Helfrich was employed by Bulk Distribution Centers ("Bulk"). Bulk maintained an employer-sponsored 401(k)(1) profit sharing plan, which was covered by the Employee Retirement Income Security Act, 29 U.S.C. § 1001, *et seq.* ("ERISA"). PNC Bank, Kentucky, Inc., administered the plan for Bulk.

In Spring 1996 Helfrich properly instructed the Bank to roll over approximately \$700,000 into specified mutual fund accounts. The Bank mistakenly failed to carry out this instruction. When Helfrich discovered the Bank's error he filed a lawsuit, alleging that the Bank had breached its fiduciary duty to him in violation of ERISA. He sought what he termed "restitution" of the difference between the amount he would have earned if the Bank had completed the requested rollover and the amount he had actually earned.

What Constitutes Restitution?

ERISA restricts plan beneficiaries, like Helfrich, to equitable relief with no recourse to money damages. *See* 29 U.S.C. § 1132(a)(3). The Bank argued that Helfrich's suit sought nothing more than money damages and therefore was not a proper ERISA action. Helfrich argued that the money he sought was in the nature of restitution, an equitable remedy. The federal district court agreed with Helfrich and would have let his case proceed to a trial but the Bank asked permission to appeal immediately. The district court granted permission.

On appeal, the Sixth Circuit agreed with the Bank that Helfrich was really seeking money damages, a remedy *not* available under ERISA to a beneficiary like Helfrich. The court quoted an Eighth Circuit case to define the difference between restitution and money damages:

"A restitutionary award focuses on the defendant's wrongfully obtained gain while a compensatory award focuses on the plaintiff's loss at the defendant's hands."

Kerr v. Charles F. Vatterott & Co., 184 F.3d 938, 944 (8th Cir. 1999).

Bank Did Not Gain

The Sixth Circuit explained that, if the Bank had somehow gained from a misdeed, Helfrich would be entitled to maintain an ERISA action to recover restitution. But, here, where Helfrich sought to recover only an amount he lost as a result of the Bank's mistake, ERISA provided no remedy.
