Loyola Consumer Law Review

Volume 2 | Issue 2 Article 7

1990

# Tenth Circuit Holds That Federal Common Law Limits Uninsured Depositors' Recovery from Insolvent Lending Institution to Pro Rata Share of Assets

Eileen B. Libby

included equal rights to manage and control the partnership (Wash Rev. Code §§ 25.04.180(5) and .240(3)), equal access to the business records (Wash Rev. Code § 25.04.190), and limited transferability of the general partnership interests (Wash Rev. Code § 25.04.180(7)). The general partnership agreement also provided that Sadri and Teuscher were to share the profits and losses equally. In addition, the court noted that although Sadri presented evidence that Teuscher had primary responsibility for managing BMS, Sadri presented no evidence that Teuscher prevented Sadri from exercising his partnership rights. Therefore, because Sadri failed to establish the third element of the investment contract definition, the court held that Sadri could not recover under either the federal or state securities laws.

### The Washington Consumer Protection Act

Sadri and the twelve limited partners alleged that Teuscher's misrepresentations also violated Washington's Consumer Protection Act. Wash. Rev. Code §§ 19.86.010 - .920 (1989) ("the CPA"). Under the CPA, the plaintiff must prove (1) an unfair or deceptive act or practice (2) in trade or commerce (3) which affected the public interest; (4) injury to plaintiff; and (5) a causal connection between the unfair or deceptive act and the injury suffered. *Travis v. Washington Horse Breeders Ass'n, Inc.*, 111 Wash. 2d 396, 759 P.2d 418, 422-423 (1988). On appeal, Teuscher argued that Sadri and the twelve limited partners had not established the first, third and fifth elements of the test. The court rejected Teuscher's argument with respect to the limited partners, but agreed that Sadri's claim failed because he did not establish that the deceptive acts affected the public interest.

**The Twelve Limited Partners.** The court stated that to prove the first element, the plaintiff must show that the alleged act had the capacity to deceive a substantial portion of the public. The plaintiff, however, need not demonstrate that the defendant actually intended to deceive anyone. The court held that the twelve limited partners satisfied this first element by showing that the Teuscher's misstatements were made to many investors. In fact, Teuscher sought out any investor who had large amounts of cash. Thus, a substantial portion of the public could have been deceived by Teuscher's misstatements.

Next, the court addressed the public interest element of the twelve limited partners' CPA claims. The defendant's acts affected the public interest if there is a likelihood that others were injured in the same manner as the plaintiffs. The court identified four factors to be considered in determining whether the required public interest element of the CPA claim was satisfied: (1) the act was committed in the defendant's business; (2) the defendant advertised to the public; (3) the plaintiff was actively solicited by the defendant; and (4) the plaintiff and defendant occupied unequal bargaining positions. Not all of these factors need be met, nor is any one dispositive.

In this case, Teuscher acted in the scope of his business. He did not advertise to find investors, but he nonetheless actively solicited investors. Teuscher occupied a superior bargaining position because the twelve limited partners were not sophisticated in the real estate business and Teuscher was their only source of information about the investment. Taking all of the factors into account, the court found that the twelve limited partners had adequately established the public interest element of their CPA claims.

Finally, the court held that the twelve limited partners had established the causation element of a CPA claim. The court found that had the twelve limited partners known the truth about BMS, they would not have invested. Therefore, the twelve limited partners could recover under the CPA.

**The General Partner.** The court held that Sadri, however, had failed to prove his CPA claim. His participation in the project was not actively solicited by Teuscher. Sadri was a sophisticated businessman with years of experience in real estate development. He negotiated extensively with Teuscher before forming the general partnership. Thus, the court held that Sadri failed to meet the public interest element of his CPA claim because he did not prove that Teuscher had superior bargaining power. Therefore, the court reversed the jury's decision and directed judgment for Teuscher on Sadri's CPA claim.

**Sean J. Hardy**

## Tenth Circuit Holds that Federal Common Law Limits Uninsured Depositors' Recovery from Insolvent Lending Institution to Pro Rata Share of Assets

In ***Downriver Community Federal Credit Union v. Penn Square Bank***, 879 F.2d 754 (10th Cir. 1989), the United States Court of Appeals for the Tenth Circuit held that uninsured depositors who were fraudulently induced to deposit money into the now-defunct Penn Square Bank were entitled to recover only a pro rata share of the bank's assets. In so holding, the court stated that federal common law, rather than state law, governs the post-insolvency relationship between national banks and their depositors.

### Background: Credit Unions were Fraudulently Induced to Purchase Certificates of Deposit

In December 1981, Downriver Community Federal Credit Union ("Downriver") and Wood Products Credit Union ("Wood Products") received glowing financial reports regarding the Penn Square Bank of Oklahoma City ("Penn Square"). The reports were made by investment brokers whose fees were paid by Penn Square. In reliance upon these reports, Downriver and Wood Products purchased 4.5 million dollars in Penn

(continued on page 50)

## Uninsured Depositors (from page 49)

Square certificates of deposit. On July 5, 1982, the Comptroller of the Currency of the United States declared Penn Square insolvent and appointed as receiver the Federal Deposit Insurance Corporation ("FDIC"). At that time, forty-seven commercial banks, forty-eight savings and loan institutions and one hundred forty credit unions, including Downriver and Wood Products, held uninsured deposits in Penn Square.

Immediately following Penn Square's collapse, Downriver and Wood Products filed suit in the United States District Court for the Western District of Oklahoma charging Penn Square with knowingly or recklessly inducing their deposits by issuing materially misleading financial statements.

### District Court Imposes Constructive Trust on Penn Square Assets

The district court divided the ensuing litigation into two discrete phases: liability and remedy. The first phase addressed whether Penn Square and its directors fraudulently misrepresented the bank's fiscal condition in its financial statements, and whether Downriver and Wood Products relied on those statements in purchasing the certificates of deposit. Downriver and Wood Products prevailed on both issues.

The second phase of the trial addressed the appropriate remedy. The district court held that Oklahoma law governed the case. According to Oklahoma law, a court may impose a constructive trust on an insolvent bank's assets if three conditions are met: the bank acquired the plaintiff's deposits by fraud; the deposits increased the bank's assets; and the court is able to trace the plaintiff's deposits into the defendant's assets. The district court held that these three conditions were met. The court also found that imposing a constructive trust would not be unfair to Penn Square's other depositors because the constructive trust would have only minimal impact on the assets available to other depositors. In addition, the other depositors also could have sought constructive trusts. Accordingly, the district court imposed a constructive trust on the amount of Downriver and Wood Products' deposits and the interest that had accrued to the date of insolvency.

### Court of Appeals: Federal Law Applies Whenever a National Bank is Declared Insolvent and Placed Into Receivership

The court first addressed the threshold issue of whether to apply state or federal law. Downriver and Wood Products argued that Oklahoma law governed their pre-insolvency relationship with Penn Square and that, under Oklahoma law, their deposits never became part of Penn Square's assets because the deposits were obtained by fraud.

The court of appeals agreed that state law governs the relationship between a national bank and its depositors prior to the bank's insolvency. The court noted, however, that Congress has the paramount authority to regulate national banks. Therefore, state law applies only in the absence of federal law or, where there is federal law that regulates the banks, state law applies only to the extent that the state law does not conflict with applicable federal law. Congress enacted the National Bank Act, 12 U.S.C. §§ 21 - 216(d) (1988) (originally enacted as an Act of June 3, 1864, ch. 106, § 5, 13 Stat. 100) ("the Act"), to govern insolvent banks. Therefore, the Act governs all claims on an insolvent bank's assets.

The court recognized, however, that the Act does not provide specific rules for distributing an insolvent bank's assets and therefore does not address all of the problems that might arise in distributing the bank's assets. The court held that to the extent that the Act does not provide specific rules for distribution, the equitable doctrines developed by the federal courts apply. In other words, federal common law governs where the Act does not provide a specific rule governing insolvent banks.

### Federal Common Law Precludes Imposition of Constructive Trust

The court of appeals turned next to the propriety of the district court's remedy. Generally, in fashioning federal common law, federal courts may look for guidance to the law of the state having the closest connection to the transaction at issue. If, however, there is a need for a uniform federal policy, or if applying the state law would interfere with congressional objectives, federal courts must turn to federal law.

The court of appeals noted that, in creating the Act, Congress sought to achieve orderly liquidation of the insolvent bank's assets and equitable distribution among all creditors entitled to a share of the bank's assets. Oklahoma law permitted full restitution only to some of an insolvent bank's depositors. The court held that this remedy would interfere with the Act's objectives by disrupting the orderly distribution of the insolvent bank's assets and favoring certain creditors over others. Therefore, the court refused to apply Oklahoma law to the case.

The court noted, however, that under federal law a depositor could establish a preferential claim to the insolvent bank's assets if the bank's fraud caused the depositor a particular harm not shared by substantially all of the other depositors. The court found that many other financial institutions had relied on the investment brokers' financial reports in deciding to deposit money into Penn Square. The court held that because Downriver and Wood Products were not unique in their reliance on these reports, they could not obtain preferential claims to Penn Square's assets.

Downriver and Wood Products argued that the court still could impose a constructive trust if all depositors who relied on the financial reports filed a class action suit.

The court rejected this argument. If a class action suit were allowed, uninsured depositors would race to the FDIC in order to assert a preferred claim. The court concluded that this result would make a "mere mockery" of the equality promised by the National Bank Act. Where a fraud affected or potentially affected all depositors, all depositors should be treated the same. Therefore, the court held that a pro rata distribution of assets among all of Penn Square's depositors was the only fair remedy.

**Eileen B. Libby**

## Mandatory Inclusion of Commercial Leases in a Cooperative Conversion of Rent Stabilized Apartments Did Not Violate the Sherman Act

Recently, in ***305 East 24th Owners Corp. v. Parman Co.,*** 714 F. Supp. 1296 (S.D.N.Y. 1989), the United States District Court for the Southern District of New York held that a seller's including four long term commercial leases in its offer to convert rent stabilized apartments into cooperative units did not constitute an illegal tying arrangement in violation of the Sherman Act. 15 U.S.C. §§ 1 - 7 (1989). In applying the Second Circuit's five-pronged test to determine whether an illegal tying arrangement existed, the court ruled that the tenants failed to show that the sellers had economic power in the tying product market or that the seller's acts had a substantial anticompetitive effect in the tied product market. Additionally, the court concluded that the commercial lease provision of the conversion contract was not unconscionable because the tenants had meaningful choices in deciding to enter into the contract and the contract terms were not unreasonably favorable to the sellers.

### Background

In August of 1980, Parman Co. ("Parman") submitted to the New York State Attorney General a preliminary offering plan to convert the rent stabilized apartments at 305 East 24th Street to cooperative ownership. Under a cooperative conversion, the tenants purchase stock in and become sole owners of the corporation that owns the residence building. The amount of stock a tenant owns represents the value of that tenant's residence. Parman's preliminary offering plan provided that any tenant who chose not to buy into the cooperative would have to vacate the building when it was converted from an apartment to a cooperative. In addition, the plan required that Owners Corp. (the corporation of tenants which owned the building under the cooperative agreement) enter four long term leases enabling the sellers to retain control of the commercial management services, garage services, laundry services, and building management services.

The tenants formed the 305 East 24th Street Tenants' Association ("Tenants' Association" or "Association") and took a number of actions to improve their position in negotiating the cooperative conversion agreement. First, the Tenants' Association retained legal counsel familiar with cooperative conversions. Second, eighty percent of the tenants signed No-Buy Agreements which stated that no tenant who signed the Agreements would purchase cooperative shares until two thirds of the tenants signed releases from the Agreements. Third, the Association sent letters to the tenants on a continuing basis to inform them of the progress in the negotiations. The letters made particular reference to the disputed long term leases.

On January 25, 1983, Parman submitted a formal offering plan to the New York State Attorney General's Office. The formal plan contained the same commercial lease agreements. The cover of the plan included the admonition "See 'Special Risks' Page 1" in bold print. A portion of the "Special Risks" section read, "These leases may not be 'arms-length' transactions and may result in [Owners Corp.] realizing *less* than the full economic value of the garage space and commercial space." (emphasis in the original) Unlike the preliminary plan, however, the formal plan proposed a non-eviction conversion. Thus, if a tenant chose not to buy her shares of the cooperative, she could remain in the building as a rent stabilized tenant.

On August 12, 1983, the Tenants' Association sent Parman a letter proposing to reduce the price per share in the Owners Corp., to reduce the downpayment required to purchase shares, and to increase the rent for the commercial leases. On April 6, 1984, after negotiating with the Tenants' Association, Parman amended the offering plan to incorporate a number of the Association's demands: the price per share in the Owners Corp. was reduced by 25% for current tenants buying into the cooperative; the down payment was reduced from 10% of the purchase price to a flat sum of one thousand dollars; Parman agreed to obtain financing for those tenants unable to acquire it otherwise; and Parman agreed to pay thirty-five thousand dollars of the Tenants' Association's legal fees. The commercial leases were left intact.

Following a Tenants' Association question and answer session regarding the amended plan, the Association's five-member Executive Committee recommended that the tenants sign releases from the No-Buy Agreements. By October 25, 1984, the date of the closing, eighty-five percent of the tenants had signed agreements with Parman to buy shares in Owners Corp.

Owners Corp. sued Parman in the United States District Court for the Southern District of New York to prevent the conversion. Owners Corp. argued that the conversion agreements violated the Sherman Act antitrust provision and that the commercial leases were unconscionable.

### Subject Matter Jurisdiction

Parman argued that the district court did not have subject matter

(continued on page 52)