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Commonwealth of Kentucky

Court of Appeals

NO. 2018-CA-001259-MR

STEPHEN B. PENCE AND THOMAS BEAN — APPELLANTS

APPEAL FROM JEFFERSON CIRCUIT COURT
v. HONORABLE JUDITH E. MCDONALD-BURKMAN, JUDGE
ACTION NO. 10-CI-405021

VNB NEW YORK, LLC AS SUCCESSOR BY MERGER TO VNB NEW YORK CORPORATION, AS SUCCESSOR IN INTEREST TO THE PARK AVENUE BANK; ALEXANDER & ALEXANDER RISK SERVICES, LLC; AVIATION SOLUTIONS, LLC; RIVER FALLS HOLDINGS, LLC; RIVER FALLS INVESTMENTS, LLC; SDH REALTY, INC.; SHERI D. HUFF; W. ANTHONY HUFF; HUFF GRANDCHILDREN'S TRUST C/O W. ANTHONY HUFF AND SHERI D. HUFF, CO-TRUSTEES; MICHELE BROWN; RONALD E. HEINEMAN; FIFTH THIRD BANK, KENTUCKY, INC.; BLOOMFIELD STATE BANK; JAMES A. & DORIS A. ROEMER; LOCUST CREEK COMMUNITY ASSOCIATION; OXMOOR WOODS RESIDENTS ASSOCIATION, INC.; VESTA HOLDINGS I, LLC; AMERICAN TAX FUNDING, LLC; LOUISVILLE JEFFERSON COUTY METRO GOVERNMENT; CITY OF HURSTBOURNE, KENTUCKY; AND CITY OF MIDDLETOWN, KENTUCKY — APPELLEES

OPINION
AFFIRMING

** ** ** ** **

BEFORE: ACREE, COMBS, AND MAZE, JUDGES.

COMBS, JUDGE: Stephen Pence and Thomas Bean appeal from an order of the Jefferson Circuit Court granting summary judgment to VNB New York, LLC, successor by merger to VNB New York Corporation, successor in interest to Park Avenue Bank, a New York State chartered bank, ("VNB") now shuttered but formerly headquartered in New York, New York. After our review, we affirm.

This case has a lengthy procedural history which includes a prior appeal to this court. Litigation began in December 2010, when VNB filed a complaint in the Jefferson Circuit Court against numerous defendants, among whom were Pence and Bean. The complaint alleged that Pence and Bean breached a guarantee that they had executed *personally promising* the repayment of any sums loaned by Park Avenue Bank under a revolving line of credit extended to River Falls Holdings, LLC, and River Falls Investments, LLC. In March 2009, in his capacity as manager of River Falls Holdings, Pence executed the revolving-line-of-credit promissory note. Bean was manager of River Falls Investments and executed the revolving-line-of-credit note in his capacity as its manager.

On March 23, 2009, pursuant to Pence's direction, Park Avenue Bank disbursed $1,485,000 under the revolving line of credit into a checking account of

River Falls Holdings – an account opened by Pence on November 4, 2008, in his capacity as manager of the company. Thereafter, $1,480,000 was transferred from the River Falls Holdings' checking account to an account at Park Avenue Bank held by SDH Realty, Inc., a Kentucky corporation. Pence authorized the transfer of the loan proceeds. The president of SDH Realty was Sheri D. Huff; Wilbur Anthony Huff was the vice-president.

On March 12, 2010, the New York Banking Department seized Park Avenue Bank as a failed bank. The Federal Deposit Insurance Corporation (FDIC) was appointed as receiver for the bank. In its capacity as receiver, the FDIC eventually entered into a Purchase and Assumption Agreement and an Assignment and Purchase Agreement with Valley National Bank New York Corporation (VNB). Under the terms of the agreements, VNB purchased the assets and liabilities of Park Avenue Bank, which included the revolving line of credit and guarantee described above.

On April 1, 2010, River Falls Investment and River Falls Holdings defaulted under the terms of the revolving line of credit. Neither Bean nor Pence satisfied the outstanding indebtedness per the terms of their personal guarantee. As a result, VNB filed the foreclosure action referenced above and underlying this appeal. VNB alleged that Bean and Pence were jointly and severally liable per the terms of the guarantee upon default of the revolving line of credit for the

outstanding balance of $1,500,000 in principal and $288,916.82 in interest as of December 9, 2010.

Eventually, VNB filed a motion for summary judgment on the issue of Bean's and Pence's liability under the terms of the guarantee. In its memorandum of law filed in support of the motion, VNB described a broad criminal conspiracy that allegedly led to the failure of Park Avenue Bank.

In 2010, Charles Antonucci, President of Park Avenue Bank, and Matthew Morris, a senior vice-president of the bank, were indicted in federal court. According to the indictment, Antonucci and Morris had devised a plan to circumvent the policies of Park Avenue Bank so that loans to borrowers -- including the loans made to River Falls Investment and River Falls Holdings -- would appear to be legitimate to the bank's board of directors and to bank regulators. Antonucci and Morris allegedly made false representations about the borrowers' need for working capital and overstated the net worth of the guarantors. By 2013, Antonucci and Morris agreed to plead guilty to charges ranging from bank fraud to securities fraud. They also agreed to cooperate with prosecutors in the federal insurance, tax, and bank fraud case against Anthony Huff. Ultimately, Antonucci and Morris were sentenced by a New York federal court and imprisoned for their roles in the fraud scheme.

In December 2014, Huff pleaded guilty to various tax crimes and to a massive bank and insurance fraud that involved the bribery of Antonucci and Morris. In 2015, Huff was sentenced to serve 12 years in prison and to pay $108,000,000 in restitution.

In their responses to the bank's motion for summary judgment in the foreclosure action, Bean and Pence asserted that they were unaware of the fraud scheme and explained that they were victims of Huff and Park Avenue Bank executives. They contended that the guarantee was unenforceable against them since it was an illegal agreement and was the product of fraud in the *factum*.

The Jefferson Circuit Court referred the motion for summary judgment to its master commissioner for consideration. On August 11, 2014, the master commissioner filed a report recommending that VNB's motion for summary judgment against Bean and Pence be granted. The master commissioner concluded as follows:

> Pence and Bean have not alleged any facts which fall into the category of fraud in the factum. They do not dispute that they knew they were signing a guarant[ee]. The terms of the guarant[ee] were spelled out in the instrument they each signed and the contents of the instrument were not changed after they signed it. The Sixth Circuit Court of Appeals has construed *D'Oench [Duhme & Co., v. FDIC,* 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed.956 (1942)] to preclude a maker from asserting any personal defenses against the FDIC, regardless of the maker's intent, when it can be said he "lent himself to a transaction which is likely to mislead banking

> authorities." Therefore, at best, the defense of fraud which has been asserted by Bean and Pence is fraud in the inducement which is precluded by Section 1823(e).

Master Commissioner's Report at 11 (citations omitted).

On October 15, 2014, Pence filed a motion for leave to file an amended answer and counterclaim against VNB. In the amended answer, Pence sought to add the defense of fraud in the *factum* as a bar to prevent VNB from enforcing the guarantee. In the proposed counterclaim, Pence alleged that employees of Park Avenue Bank fraudulently misled and induced him to sign the guarantee. An earlier panel of this Court indicated that Bean had made an oral motion for leave to file a similar counterclaim.

By order entered on January 12, 2015, the circuit court adopted the Master Commissioner's recommendation. The circuit court concluded as follows:

> [Bean and Pence] raise [the] argument that the *D'Oench* Doctrine and § 1823 are inapplicable to void contracts. There is little dispute the promissory notes were obtained through fraud, however Pence and Bean acknowledge they knew at the time they were signing documents to obligate their respective companies. There are, however, questions as to the oral agreement to not hold them personally liable, despite the language of the notes, the date and location of their execution and purpose of the funds. Such considerations support a defense of fraud in the inducement, not fraud in the factum, and render the notes voidable not void *ab initio.*

January 12, 2015, Order at 3–4 (citations omitted).

Both Bean and Pence then filed motions seeking reconsideration of the January 12, 2015, order. Pence argued that the circuit court failed to rule on his motion to file an amended answer and counterclaim. By amended order entered on November 17, 2015, the circuit court denied the motions and also denied Pence's and Bean's motion to file an amended answer and counterclaim. The trial court concluded as follows:

> Pence and Bean are experienced businessmen, and do not dispute knowing what documents they signed. Their primary defense is that they had an oral agreement with Anthony Huff that they would not be liable and no funds were actually disbursed. However, this side agreement is the precise scenario *D'Oench* and § 1823 are designed to avoid. A failed bank's records, such as the promissory notes and mortgages, essentially are viewed in a vacuum; only errors in the written documents themselves and the institution's records can overcome *D'Oench* and § 1823. As the Court previously determined, Pence and Bean understood the terms of the documents they executed, did not raise any objections to the terms, and Park Avenue Bank's records do not reflect any amendments or alterations to those written terms. Illegal transactions may still fall within the parameters of *D'Oench.* For these same reasons, Pence's and Bean's motions to file counterclaims against VNB are also denied. They are based on the same arguments that are barred by *D'Oench*.

November 17, 2015, Amended Order at 1-2 (citations omitted). Pence and Bean filed their first appeal to this Court.

Pence and Bean presented identical arguments, and we addressed their appeals together. In our opinion, rendered June 2, 2017, *Bean v. VNB N.Y., LLC*,

2015-CA-001821-MR, 2017 WL 2399343 (Ky. App. 2017), we affirmed in part, vacated in part, and remanded the matter to the Jefferson Circuit Court for further proceedings.

Because the circuit court's conclusions were based upon application of the *D'Oench, Duhme* doctrine, we summarized it as follows:

> The *D'Oench Duhme* doctrine was initially recognized by the United States Supreme Court in *D'Oench, Duhme & Co., Inc. v. FDIC*, 315 U.S. 447, 62 S.Ct. 676, 86 L.Ed. 956 (1942), and subsequently codified by congressional act in 12 U.S.C. § 1823(e). The *D'Oench Duhme* doctrine is presently understood as shielding the FDIC or assignee bank from most claims or defenses raised to defeat its action to enforce or collect upon a debt of a failed banking institution. The modern *D'Oench Duhme* doctrine represents an amalgamation of the federal common law with 12 U.S.C. § 1823(e) to form a far reaching and consequential rule of law in the area of banking. The underlying purposes of the *D'Oench Duhme* doctrine are twofold:
>
> One purpose of § 1823(e) is to allow federal and state bank examiners to rely on a bank's records in evaluating the worth of the bank's assets. Such evaluations are necessary when a bank is examined for fiscal soundness by state or federal authorities. . . .
>
> A second purpose of § 1823(e) is implicit in its requirement that the "agreement" not merely be on file in the bank's records at the time of an examination, but also have been executed and become a bank record "contemporaneously" with the making of the note and have been approved by officially recorded action of the bank's board or loan committee These latter requirements ensure mature consideration of unusual loan transactions by senior bank officials, and prevent

> fraudulent insertion of new terms, with the collusion of bank employees, when a bank appears headed for failure . . . .

Bean at 12–14 (citations omitted).

We observed that there are recognized exceptions to the *D'Oench, Duhme* doctrine, including the defenses/claims of fraud in the *factum* and illegality of the contract. "The defenses that 'survive are those . . . that void an interest *ab initio'* thus rendering the instrument 'void' and not transferable to the FDIC." *Bean* at 14 (citations omitted.)

Having carefully considered the arguments of Pence and Bean, we concluded that they had failed to raise material issues of fact as to fraud in the *factum*. We accepted that the revolving line of credit and guarantee were part of a criminal scheme, but we noted that it was not disputed that Park Avenue Bank disbursed loan proceeds in the amount of $1,485,000 under the terms of the revolving line of credit and transferred these sums to a River Falls Holdings' checking account. We rejected the argument that the fraud that Pence and Bean had alleged constituted fraud in the *factum*. Instead, we found the allegations more consistent with fraud in the inducement, "which of course is negated under the facts of this case by the *D'Oench, Duhme* doctrine." *Bean* at 17. We concluded that the circuit court properly rendered summary judgment upon the defense of fraud in the *factum* asserted by Bean and Pence and affirmed that judgment.

With respect to the defenses/claims of illegality of the contract, we reiterated that where the effect of the illegality merely renders the underlying note or instrument voidable, the defense or claim is barred under the *D'Oench, Duhme* doctrine. However, where the effect of the illegality is to render the underlying note or instrument void, the protections of the *D'Oench, Duhme* doctrine are inapplicable.

Referring to the briefs submitted by Pence and Bean, we observed that neither set forth specific legal authority that would support a legal argument to render void the revolving line of credit or guarantee. Nevertheless, we concluded that if Huff and Antonucci -- and perhaps others -- "engaged in an elaborate shell game in the various bank loan transactions to shield a criminal enterprise unbeknownst to Pence and Bean, then their defense could possibly prevail." *Bean* at 18–19. Based upon the record before us, we noted that neither the circuit court nor the master commissioner had fully considered the issue of illegality of the underlying bank transactions as alleged by Pence and Bean. Consequently, we concluded that summary judgment was prematurely rendered upon the defense of illegality. Likewise, we concluded that their motion to file a counterclaim raising the claim of illegality was prematurely denied. We vacated the judgment and remanded for further proceedings with respect to these issues.

In an answer and counterclaim filed on September 8, 2017, Pence and Bean admitted that they had executed a "document purporting to be a Guaranty but which actually was, unbeknownst to [them], a phony document created by [Park Avenue Bank] and/or others pursuant to a criminal/illegal scheme." They re-asserted as an affirmative defense the illegality of the "loan" upon which the bank's claims are based. With respect to their counterclaim, Pence and Bean alleged that Huff and/or agents of Park Avenue Bank told them that the loan was for the business purposes of River Falls Holdings, LLC, and River Falls Investments, LLC, and that their guarantee of the loan was for legitimate business purposes. They alleged that they had executed the purported guarantee based upon the representations of Huff, which they reasonably believed to be true. They asserted that the Park Avenue Bank knew or should have known that the representations made to Pence and Bean were false and that the "fictitious loan was actually an illegal scheme." Finally, Pence and Bean alleged that the actions of Huff and the bank's representatives constituted a civil conspiracy to induce Pence and Bean to sign the guarantee at issue. They sought judgment against VNB as successor to Park Avenue Bank.

On October 18, 2017, VNB filed a motion to dismiss the counterclaim. It argued that the court lacked subject matter jurisdiction over the counterclaim because federal law required Pence and Bean to exhaust their

administrative remedies at the FDIC before filing a claim against a failed bank in *federal* court. VNB also contended that it did not have successor liability to Park Avenue Bank because it had not expressly assumed any such liability. Written discovery among the parties proceeded.

On March 30, 2018, VNB filed a motion for summary judgment with respect to the defense of illegality asserted by Pence and Bean. VNB contended that Pence and Bean had failed to offer anything whatsoever in an effort to show that either the note or guarantee was void as illegal under state or federal law. With the discovery deadline long since expired, VNB observed that neither Pence nor Bean had produced a single document, deposed a single individual, or set forth any legal authority that would support their affirmative defense.

In an opinion and order entered on June 7, 2018, the Jefferson Circuit Court granted VNB's motion to dismiss all the counterclaims, including the claim of illegality, of Pence and Bean.

In an opinion and order entered on June 20, 2018, the circuit court granted VNB's motion for summary judgment with respect to the affirmative defense of illegality. The court concluded that Pence and Bean could not show that the loan and guarantee were void *ab initio* because the note contained nothing illegal. "[V]iewing the evidence in the light most favorable to Pence and Bean, they fall into the category of 'innocent defrauded borrowers.'" Order at 6. The

court observed that this fact "does not protect them from the fact that legitimate loan documents bearing their signatures were purchased by [VNB]." *Id.* "It is the reliability of those documents that the *D'Oench* doctrine and § 1823(e) were designed to protect." *Id.*

In an opinion and order entered on July 19, 2018, the court's opinion and order granting summary judgment was made final and appealable pursuant to the provisions of Kentucky Rule(s) of Civil Procedure (CR) 54.02.

On August 15, 2018, Pence and Bean filed a motion to vacate the summary judgment pursuant to the provisions of CR 60.02(b) and (f). Alleging that they had discovered "more evidence," Pence and Bean filed the affidavit of Anthony Huff. In an affidavit executed from the federal penitentiary, Huff swore that Pence "was never intended to personally guarantee any note or loan and that [Pence] had no knowledge of the [criminal conspiracy perpetrated] at [Park Avenue Bank]." With respect to Bean, Huff indicated, "I cannot state what Bean knew or didn't know but I have no reason to believe he was aware of the [criminal conspiracy perpetrated] at [Park Avenue Bank.]" Pence and Bean argued that "the guilty pleas by Antonucci, Morris, and Huff to bank fraud and deceiving [bank] regulators together with Huff's statements in allocution would, if considered in the light most favorable to them [Pence and Bean], be sufficient to raise a question regarding the 'illegality' of the underlying conduct associated with the

guarantee[s]." They acknowledged that the question of whether the guarantee executed by Pence and Bean is void or voidable is a question of law for the court but argued that the "determination of the facts evidencing the 'illegality' of the transaction is a question for the jury." While this motion was pending before the circuit court, Pence and Bean filed a timely notice of appeal of the court's June 20, 2018 order.[1]

In this appeal, Pence and Bean present a single issue for our review: whether the circuit court erred by granting summary judgment in favor of VNB with respect to the affirmative defense of illegality. We are persuaded that it did not err in so doing.

Pence and Bean argue that the trial court improperly balanced two competing interests: an interest in enforcing the guarantee on its face *versus* a public policy interest opposing its enforcement because the underlying loan (as they contend) was part of a criminal conspiracy to defraud the bank. They argue that the guarantee was void *ab initio* because "both sides of the illegal loan transaction intended to engage in conduct in violation of federal criminal statutes." However, there is an inherent contradiction – if not misstatement -- in this

[1] A motion filed pursuant to the provisions of CR 60.02 does not affect the finality of a judgment or suspend its operation. Nor does it render a timely appeal interlocutory. Consequently, although that motion remains pending before the circuit court, our jurisdiction has been properly invoked.

argument. Neither Pence nor Bean has conceded that either one of them participated in **any** criminal conspiracy. The record on appeal contains no proof that the execution of the note and guarantee by Pence and Bean had as its purpose any intention to commit bank fraud or, indeed, any crime.

As summarized above, the provisions of 12 U.S.C. § 1823(e) were enacted to ensure that federal and state bank examiners could rely on a bank's records in evaluating the worth of the bank's assets. Consequently, seemingly unqualified notes and guarantees that are executed as part of a typical loan transaction are not subject to a defense against their enforcement. Even where senior bank officials collude with bank customers to defraud the bank, the *D'Oench, Duhme* doctrine specifically prevents the assertion of a defense against the enforcement of the customers' obligation to repay the loan.

While Pence and Bean refer to the duly executed note and guarantee as a "phony document," there is nothing on the face of their provisions that appears to be phony. The loan documents were executed prior to the bank's disbursement of funds on March 23, 2009, pursuant to Pence's direction, to a checking account opened by Pence in his capacity as manager of River Falls Holdings. Thereafter, Pence duly authorized the transfer of the loan proceeds to another account. Again, on their face, the note and guarantee reflect a perfectly ordinary loan transaction.

Nevertheless, citing the holding in *Zeitz v. Foley*, 264 S.W.2d 267 (Ky. 1954), Pence and Bean argue that we can declare their personal guarantees void on the basis that the underlying loan had as its "direct object and purpose" a violation of law. However, neither Pence nor Bean contends that they intended or were aware that the object and purpose of the loan that they sought and personally guaranteed was illegitimate or illegal in any way. The terms of the transaction were clear to the parties; Pence and Bean (managers of their companies) authorized the loan and personally guaranteed it. They have not declared that their intention in securing the loan or in authorizing the disbursement of funds was fraudulent. Thus, the ordinary loan transaction was not rendered void **at its inception** even where the loaned funds are said to have been used **thereafter** and **by others** for an illegal purpose.

Pence and Bean have acknowledged that the question of whether loan instrument is void *ab initio* is a question of law for the court to decide. Under these facts, the circuit court did not err by concluding as a matter of law that the parties' agreement was not void *ab initio*. Therefore, VNB was entitled to summary judgment as a matter of law.

We AFFIRM the judgment of the Jefferson Circuit Court.

ALL CONCUR.

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