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STATE OF NORTH DAKOTA

IN THE SUPREME COURT
STATE OF NORTH DAKOTA

PHI Financial Services, Appellee and Cross-Appellant, vs. Johnston Law Office, P.C., Appellant and Cross-Appellee, vs. Choice Financial Group, Appellee and Cross-Appellant,	**SUPREME COURT NO. 20150008** Civil No. 18-2012-CV-00577

ON APPEAL FROM THE JUDGMENT OF THE
HONORABLE THOMAS E. MERRICK DATED JANUARY
30, 2015
STATE OF NORTH DAKOTA
GRAND FORKS COUNTY DISTRICT COURT

REPLY BRIEF OF APPELLEE AND CROSS-APPELLANT, PHI FINANCIAL SERVICES, INC.

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LAW AND ARGUMENT

I. The district court properly determined PHI Financial Services, Inc. had first priority in the government disaster relief funds.

[¶1] In May 2013, PHI Financial Services, Inc. ("PHI") moved for summary judgment to determine it held a first priority security interest in the funds at issue in this case which came from a crop disaster payment received by G & K Farms ("G & K"). (Doc. #143). Choice Financial Group ("Choice") resisted PHI's motion, and asserted its security interest in the G & K disaster payment had priority over PHI's security interest. (Doc. #170). The district court granted PHI summary judgment on the priority issue, ruling PHI's security interest had priority over the lien claimed by Choice. (Doc. #232). Choice appeals, asserting it established priority through various UCC filings with the Texas Secretary of State regarding crops grown by G & K in Texas.

[¶2] The district court concluded PHI perfected its security interest on September 5, 2008 by virtue of a UCC filing in North Dakota, while Choice did not perfect its security interest until December 29, 2008. (Doc. #232, ¶ 5). The court held Choice's Texas filings were irrelevant, because priority in this matter was governed by N.D.C.C. § 41-09-21:

> While a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection and non-perfection, and the priority of a security interest in collateral. N.D.C.C. § 41-09-21(1). G&K Farms has always been located in North Dakota according the definitions found in N.D.C.C. § 41-09-27. Under N.D.C.C. § 41-09-42(1)(a) conflicting security interests "rank according to priority in time of filing or perfection." PHI's security interest in the collateral has priority over Choice's security

> interest since it is the earlier of the two security interests by more than three months.

(Id. at ¶ 6). The district court's reasoning was sound, and its priority ruling should be upheld.

[¶3] There is no dispute that, at all times material, G & K was a North Dakota general partnership. Therefore, priority was determined under North Dakota law. N.D.C.C. § 41-09-21(1). Choice argues that exceptions to this rule exist under Texas law, but this argument is foreclosed by the language of the controlling North Dakota statute. Section 41-09-21(1) provides, "Except as otherwise provided in this section, while a debtor is located in a jurisdiction, the local law of that jurisdiction governs perfection, the effect of perfection or nonperfection, and the priority of a security interest in collateral." (emphasis added). By the language of the statute, the only exceptions are those provided for in N.D.C.C. § 41-09-21. Choice does not cite any applicable exception in Section 41-09-21 which would supersede the local perfection rule, because no such exception exists.

[¶4] Choice claims an exception exists under Texas state law for the perfection of security interests in farm products. Under Tex. Bus. Com. Code § 9.302, "[w]hile farm products are located in a jurisdiction, the local law of that jurisdiction governs perfection . . . ." Choice does not explain how this foreign statute operates to supersede N.D.C.C. § 41-09-21(1), providing that the law of the debtor's location governs, and indeed no such exception exists. To the extent the

Texas statute would apply, however, Choice's argument also fails under Texas law.

[¶5] To be clear, the collateral at issue is not crops, but rather cash received from the federal government in the form of a disaster payment. Choice and Johnston have attempted to conflate the disaster payment funds with crops, but they are entirely separate assets. "Farm products" are rigidly defined in Tex. Bus. & Com. Code § 9.201(a)(34), and include crops grown or growing, livestock, supplies used in a farming operation, and products of crops in their unmanufactured state. None of these definitions encompass cash received in the form of a government payment. Other courts construing the Uniform Commercial Code have held that government payments do not constitute farm products. See e.g., In re Stevens, 307 B.R. 124, 131 (Bankr. E.D. Ark. 2004); see also, In re Curtis, 363 572, 580 (Bankr. E.D. Ark. 2007) ("Unlike perfection of crops, in order to perfect a security interest in government payments, a financing statement must be filed with the office of the Secretary of State."). Choice's argument has no basis under either North Dakota or Texas law, and perfection in this case was controlled by N.D.C.C. § 41-09-21(1).

[¶6] The financing statements filed by both parties in North Dakota directly address federal disaster funds and govern priority to the G & K disaster funds. The UCC-1 Financing Statement filed by PHI on September 5, 2008 provided that PHI was claiming a security interest in the following assets:

> All of the Debtor's crops grown or to be grown in any crop year, whether harvested or unharvested (including, but not limited to, corn, soybeans, wheat, alfalfa, and milo), all now owned or hereafter acquired products of such crops in their unmanufactured state and all now owned or hereafter acquired warehouse receipts or other documents (negotiable and non-negotiable) issued for storage of such crops; all now owned or hereafter acquired entitlements and payments (whether in chase or in kind) arising under governmental agricultural subsidy, deficiency, conservation, disaster or similar programs, all now owned or hereafter acquired seed, chemicals, fertilizer, and other supplies.

(Doc. #335, p. 1) (emphasis added). The financing statement makes clear that crops and disaster funds are two separate forms of collateral. (Id.). Choice's financing statement also recognized that "Government Payments and Programs" were assets separate and unique from growing crops, and that its security interest encompassed "[a]ll payments, accounts, general intangibles, and benefits including . . . emergency assistance and diversion payments . . . under any preexisting, current, or future federal or state government program." (Doc. #150, p. 17). It is therefore undisputed that at the time they were perfecting their security interests, both PHI and Choice understood that cash from government payments was a distinct asset sought to be secured as collateral from G & K.

[¶7] Perfection of a security interest occurs with the filing of the UCC-1 financing statement. N.D.C.C. § 41-09-30. PHI's financing statement, encompassing government payments received by G & K, was filed on September 5, 2008. (Doc. #335). Choice's financing statement, also encompassing government payments received by G & K, was not filed until December 29, 2008. (Doc. #150). Accordingly, it cannot be disputed that PHI holds priority over

Choice in the disaster funds wrongfully held by Johnston in this matter. The district court's ruling should be affirmed.

II. Johnston did not provide value to G & K.

[¶8] The district court voided the bulk of the transfer to Johnston under N.D.C.C. § 13-02.1-04(1)(a), which authorizes such action when the debtor made the transfer with "actual intent to hinder, delay, or defraud any creditor of the debtor[.]" (Doc. 403, ¶¶ 34-37). The court found that "clear and convincing evidence" established that G & K, through Tom and Mari Grabanski, acted to hinder, delay, and defraud its creditors. (Id. at ¶ 34). These actions by the debtor require that the entire transfer to Johnston be invalidated, irrespective of any actions by Johnston or any measure of reasonably equivalent value. Therefore, the court's award of $35,000.00 to Johnston must be reversed.

[¶9] To the extent reasonably equivalent value is considered for purposes of invalidation under N.D.C.C. §§ 13-02.1(4)(1)(b) and 13-02.1-05, Johnston's arguments that it gave reasonably equivalent value to G & K are unavailing. Johnston's continued assertion that G & K and Texas Family Farms are the same entity is squarely contradicted by Johnston's own filings and actions. In various court filings, Johnston:

- Prepared a Schedule B listing G & K and Texas Family Farms as separate entities (Doc. #385, p. 6);
- Listed separate net worth values for each entity (-$5,312,484.69 for G & K and -$2,520,143.09 for Texas Family Farms) (Id.);

- Prepared a Summary of Schedules with an attachment that listed G & K and Texas Family Farms as separate entities, with separate Employer Identification Numbers (Doc. #378, p. 14);

- In March 2012, filed a proof of claim in the Keeley-Grabanski Land Partnership case naming G & K as a creditor, long after G & K had purportedly transformed itself into Texas Family Farms. (Doc. #367).

Johnston also did not challenge the finding of the United States Bankruptcy Court for the District of North Dakota that Grabanski "abandoned G&K Farms and created a new entity, Texas Family Farms, LLC." (Doc. #370, p. 6).

[¶10] There is also no merit to Johnston's claim that reasonably equivalent value was indirectly received by G & K through Johnston's overall representation of Tom Grabanski and his entities. The district court took pains to make clear that Johnston was permitted to retain this sum because it approximated an amount rendered to G & K alone—the only Grabanski entity which had any right to the government disaster funds. (Doc. #403, ¶¶ 36-37). Therefore, this finding forecloses Johnston's claim that it was allowed to retain funds on a "common benefit" theory as a result of representing all Grabanski entities. The court concluded that "15-25% of the legal fees can be attributed to G & K and all the litigation it spawned", and therefore permitted Johnston to retain $35,000 of the $150,000 originally kept by Johnston for alleged services rendered. (Id.)

[¶11] As explained at length in PHI's initial brief, however, G & K was long-defunct by the time Johnston assumed representation. G & K ceased operating in the spring of 2009, and Johnston did not begin any representation of Tom and

Mari Grabanski until the summer of 2010. (Tr. 108:18-20; 146:20-24). By the time Johnston began representation, G & K had no assets to protect, and no benefit to be derived from any legal services. Johnston is entitled to no portion of the windfall unexpectedly received by G & K in 2011, because no value was ever provided to G & K through the course of Johnston's representation.

CONCLUSION

[¶12] The collateral at issue in this case is cash received by G & K through a government disaster payment. PHI perfected its security interest in this collateral more than three months before Choice by filing a UCC-1 Financing Statement. The court's determination of priority should be affirmed. Additionally, Johnston's arguments as to value provided to G & K are unavailing. Because G & K could not have received any value from Johnston, PHI is entitled to the entire $170,400.00 transferred from the G & K disaster payment to Johnston.

Respectfully submitted July 29, 2015.

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District Court No. 18-2012-CV-00577
SUPREME COURT NO. 20150008

STATE OF NORTH DAKOTA)
) SS
COUNTY OF CASS)

AFFIDAVIT OF SERVICE BY ELECTRONIC MAIL

Tracy A. Ottum, being first duly sworn upon oath, deposes and says that she is of legal age and not a party to the above-entitled matter.

On July 29, 2015, Affiant delivered via e-mail a true and correct copy of the following document:

REPLY BRIEF OF APPELLEE AND CROSS-APPELLANT, PHI FINANCIAL SERVICES, INC.

A copy of the foregoing was securely e-mailed to the addresses as follows:

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The best of Affiant's knowledge, the e-mail addresses above given are the actual e-mail addresses of the parties intended to be so served and said parties have consented to service by e-mail.

Tracy A. Ottum

Subscribed and sworn to before me this 29th day of July, 2015.

SONIE J. THOMPSON
Notary Public
State of North Dakota
My Commission Expires Aug. 13, 2016

(SEAL)

Notary Public, Cass County, North Dakota

RE: PHI Financial Services v Johnston Law Office, P.C., et al
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Tracy A. Ottum, being first duly sworn upon oath, deposes and says that she is of legal age and not a party to the above-entitled matter.

On August 3, 2015, Affiant delivered via e-mail a true and correct copy of the following document:

REPLY BRIEF OF APPELLEE AND CROSS-APPELLANT, PHI FINANCIAL SERVICES, INC.

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The best of Affiant's knowledge, the e-mail addresses above given are the actual e-mail addresses of the parties intended to be so served and said parties have consented to service by e-mail.

Tracy A. Ottum

Subscribed and sworn to before me this 3rd day of August, 2015.

SONIE J. THOMPSON
Notary Public
State of North Dakota
My Commission Expires Aug. 13, 2016
(SEAL)

Notary Public, Cass County, North Dakota