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STATE OF NORTH DAKOTA

In the Supreme Court
State Of North Dakota

May 19, 2015

Supreme Court No. 20150008

PHI Financial Services, Inc.,

Plaintiff, Appellee and Cross-Appellant,

v.

Johnston Law Office, P.C.,

Defendant, Appellant, and Cross-Appellee

Choice Financial Group,

Defendant, Appellee and Cross-Appellant.

Supreme Court No. 20150008

Grand Forks County Number: 18-2012-CV-00577

APPEAL FROM FINAL JUDGMENT
THE DISTRICT COURT OF GRAND FORKS, NORTH DAKOTA
NORTHEAST CENTRAL JUDICIAL DISTRICT
THE HONORABLE THOMAS E. MERRICK, PRESIDING

INITIAL BRIEF OF DEFENDANT, APPELLANT, AND CROSS-APPELLEE
JOHNSTON LAW OFFICE, P.C.

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[2] **STATEMENT OF THE ISSUES**

a. Did the District Court commit error by holding Johnston Law Office liable for a transfer of funds to an insider where the District Court found Johnston Law Office acted as a mere conduit for the transfer?

b. Did the District Court commit error by voiding a portion of the $145,774.63 dollar amount of a transfer of funds to Johnston Law Office where the Court expressly found that: (1) reasonably equivalent value had been provided by Johnston Law for the full amount of the transferred funds; (2) Johnston Law was a good faith transferee; and (3) Johnston Law had not acted in bad faith toward creditor PHI?

c. Did the District Court commit error by holding that creditor PHI was not barred by the doctrine of *res judicata* from pursuing UCC Article 9 remedies after PHI had already obtained a money judgment relative to those funds?

d. Did the District Court commit error by holding that the doctrine of *res judicata* determined that PHI held a perfected security interest in the funds received by Johnston Law Office?

e. Did the District Court commit error by holding that creditor PHI held a perfected security interest in the funds which were eventually transferred to Johnston Law Office?

f. The District Court erred in its calculation of pre-judgment interest as PHI's right to recovery did not vest on the date of the transfer.

[3] **STATEMENT OF THE CASE**

[4] The instant appeal derives from a final judgment which was entered in the District Court following a bench trial held on August 12-13, 2014. **[App 162].**

[5] In a written "Memorandum and Order for Judgment" entered on December 30, 2014, by the Honorable Thomas E. Merrick, the District Court ordered judgment be entered against Johnston Law Office, P.C. (*"Johnston Law ")* in the amount of $135,400.00, with prejudgment interest accruing on the first $115,000.00 at the rate of $18.91 per day and on the remaining $20.400.00 at the rate of $3.36 per day, with post judgment interest to accrue at the rate of 6.5% per year. **[App 162]**. Judgment was entered on January 30, 2014. **[App 162]**.

[6] This civil action was commenced by Appellee/Cross-Appellant PHI Financial Services, Inc. (*hereinafter "PHI"*), on January 3, 2012. **[App 14]**. PHI's cause of action against Johnston Law were: (1) conversion; (2) fraudulent conveyance (actual fraud); and (3) fraudulent conveyance (constructive fraud). **[App 14]**. On July 12, 2012, PHI filed an Amended Complaint in which PHI named Choice Financial as a defendant alleging PHI's security interest was in first place. **[App 23].**

[7] On May 16, 2013, PHI filed a motion for summary judgment, requesting summary adjudication of PHI's claims against Johnston Law, and an order giving PHI priority with respect to the co-defendant Choice Financial. [**Docket (Doc) 165**].

[8] On June 19, 2013, Johnston Law filed its opposition to the PHI motion for summary judgment, and cross-motioned for summary judgment alleging PHI had failed to perfect a security interest in the funds at issue. [**Doc 188**]**.**

[9] On August 19, 2013, the District Court issued an order denying summary judgment to PHI, while also denying Johnston Law's summary judgment motion without making any

findings stating in conclusory fashion—"PHI perfected its security interest on September 5, 2008 in North Dakota", and that because "Choice did not perfect its security interest in North Dakota until December 29, 2008", giving PHI priority over Choice. [**App 43-44**]. As the District Court noted in its "Memorandum and Order for Judgment" on December 30, 2014, "because of an earlier ruling that the security interest of Choice in the collateral at issue is subordinate to the security interest of PHI, Choice did not participate in the trial." [**App 152].** Choice did not challenge the order disposing of the various summary judgment motions.

[10] Prior to trial, Johnston Law moved the court to bifurcate trial by addressing the following two issues in sequence: (1) whether PHI had a *perfected* security interest in the SURE payment; and (2) contingent upon the court's determination of the first issue, whether the transfer of funds constituted collusion or fraudulent transfer. [**App 70-71**]. At the hearing on Johnston Law's motion to bifurcate the trial, PHI argued the issue was barred by res judicata originating with North Dakota Federal District Court Case No. 2:10-cv-28. [**App 77-90**]. The North Dakota Federal District Court never found nor ordered that the PHI security interest achieved "perfection" and the terms "perfected" or "perfection" are notably absent. The North Dakota Federal District Court determined that PHI possessed a valid security interest. Being distinct legal findings—"attachment" of a security interest is not synonymous with "perfection" of a security interest—the North Dakota Federal District Court did not deliver what PHI was selling.

[11] The District Court issued its "Memorandum and Order for Judgment" on December 30, 2014. [**App 152**]. Appellant/Cross-Appellee Johnston Law filed a timely Notice of Appeal on January 21, 2015 [**App 163**], with Appellee/Cross-Appellant PHI filing its Notice of Cross-Appeal on January 26, 2015 [**App 166]**, and Appellee/Cross-Appellant Choice Financial filed its Notice of Cross-Appeal on February 16, 2014 [**App 168].**

STATEMENT OF THE FACTS

[12] Johnston Law represented Tom and Mari Grabanski who owned a number of related farming entities and joint ventures, including G & K Farms, which is the predecessor of Texas Family Farms (G&K/TFF), Keeley Grabanski Land Partnership (KGLP) and Grabanski Grain. These related enterprises, referred to as the Grabanski entities, had a long standing practice of sharing resources, cross collateralizing assets, performing services for each other, and paying accounts receivable on behalf of one another. [**App 367, 368, 385, 386**]. The Grabanski entities also shared capital and loan proceeds to meet payment deadlines. [***Id.***].

[13] Johnston Law represented Tom and Mari Grabanski in a personal chapter 11 bankruptcy filed on July 22nd, 2010. [**App 202**]. The personal chapter drew other Grabanski entities into various related proceedings over the next two years, as Johnston Law represented the Grabanskis and their entities in eleven law suits. [**Doc 328**]. G&K/TFF was never formally under the jurisdiction of the bankruptcy court but was a named party in a majority of the law suits in which Johnston Law Office represented the Grabanskis' or their entities' interests. [**Doc 328**].

[14] In September of 2009, Tom Grabanski informed DeWayne Johnston of Johnston Law that a crop disaster payment (SURE payment) of $328,168 was to be distributed to G&K/TFF as a result of 2009 Texas crop disaster determinations. [**App 229-234**]. G&K/TFF had creditors and Tom sought the legal advice of his counsel regarding the status of that SURE payment as collateral. DeWayne Johnston reviewed the information available to him and advised G&K/TFF that only certain debtors could be paid with funds from the SURE payment. [**App 233, 234**].

[15] Though Choice and PHI had filed financing statements listing G&K/TFF assets, DeWayne Johnston as counsel for the Grabanski entities noted several errors in the potential lien status of Choice and PHI, leaving the SURE payment free of any perfected security interest.

[**App 236**]. G&K/TFF's current checking account was held at Choice in North Dakota. Johnston Law advised G&K/TFF that if G&K/TFF deposited the SURE payment in a Choice bank, Choice would be in the position to effectuate an illegal set-off against all monies deposited into the North Dakota Bank. [**App 233, 234**]. G&K/TFF opened a bank account in Texas and on October 11, 2011, the SURE payment was deposited into that account. [**Doc 328**].

[16] G&K/TFF used the SURE payment money to pay its creditors. G&K/TFF and the related Grabanski entities owed Johnston Law roughly $150,000 in legal fees. [**App 259-260**]. G&K/TFF deposited into the Johnston Law trust account $170,400 which occurred in two separate transactions dated October 11, 2011 (deposited October 14, 2011) and October 27, 2011 (deposited November 4, 2011). [**Doc 328**].

[17] Johnston Law was instructed to transfer $24,225.37 from trust on October 31, 2011 to indemnify Merlyn Grabanski for monies he was required to pay on behalf of G&K\TFF during the previous year. The remaining $145,774.63 was paid to Johnston Law for legal services on October 14, 2011, November 4, 2011, and April 18, 2012 with the payments applied to invoices detailing work for G&K\TFF and related entities. **[App 219, Doc 328**].

[18] On January 3rd, 2012, PHI filed a complaint against Johnston Law seeking relief for fraudulent conveyance and conversion. [**App 14**].

STANDARD OF REVIEW

[19] The dispositive issues presented by Appellant/Cross-Appellee Johnston Law in the instant appeal implicate pure questions of law and are thus reviewed under the *De Novo* standard of review. *Bolinske v. Herd*, 2004 ND 217, ¶ 7, 689 N.W.2d 397, 400 (N.D. 2004); (stating *de novo* standard of review is used for legal conclusions and a clearly erroneous standard for factual findings). Whether a "mere conduit" for the transfer of funds may be held liable for constructive fraud is a question of law to be analyzed within the contours of N.D.C.C. § 13-02.1-08(2); and *Watts v. Magic 2 x 52 Management, Inc.*, 2012 ND 99, ¶¶ 14 & 18, 816 N.W.2d 770, 775-776 (N.D. 2012). Whether a good faith transferee may be liable to another for any part of a transfer found to be for reasonably equivalent value is a legal conclusion to be reviewed *de novo*. N.D.C.C. 13-02.1-08(1). Whether the doctrine of r*es judicata* serves to bar a creditor's UCC Article 9 collection remedies is a question of law as well. *Hofsommer v. Hofsommer Excavating*, 488 N.W.2d 380, 383 (N.D. 1992); *Liberty Loan Corp. v. Wallace [In re Wilson]*, 390 F.Supp. 1121, 1123 (D. Kan. 1974); Whether the District Court committed error by concluding that PHI's security agreement was perfected by the doctrine of *res judicata* is also a question of law. Finally, whether PHI possessed a ***perfected*** security interest in the transferred funds based upon the record in this case is also an issue of law. *First National Bank in Creston v. Francis*, 342 N.W.2d 468, 470-471 (Iowa 1984).

[20] Issues of fact may become issues of law if reasonable persons could reach only one conclusion from those facts, and the Supreme Court reviews questions of law under a *de novo* standard of review. *State v. B.B.*, 2013 ND 242, ¶7, 840 N.W.2d 651, (N.D. 2013); *Schipper Construction, Inc. v. American Crystal Sugar Company*, 2008 ND 226, ¶12, 758 N.W.2d 744, 748 (N.D. 2008).

[21] Additionally, the District Court made findings of fact which cannot be set aside unless those findings are clearly erroneous, and Appellant/Cross-Appellee Johnston Law maintains that the District Court's findings, ***relative to those issues which Johnston Law raises in the instant appeal***, are not clearly erroneous, and that these findings of fact by the District Court should not be disturbed by the Supreme Court on appeal. *Ludwig v. Burchill*, 514 N.W.2d 674, 676 n.1 (N.D. 1994).

LAW AND ARGUMENT

I. The District Court erred in assigning liability to Johnston Law for its role as a mere conduit in the $24,225.37 transfer of funds involved in this case.

[22] A party who acts as a conduit for a fraudulent transaction cannot be liable for that transaction. The District Court determined that Johnston Law was a conduit for the transfer of $20,400 ($24,225.37 is the correct amount that went to Merlyn Grabanski) from G&K Farms to Merlyn Grabanski, yet the Court nevertheless classified it as a fraudulent transfer. [**App 156**]. While the District Court found Johnston Law to be liable for the transfer as the first transferee, the Uniform Fraudulent Transfer Act requires that a party be more than a mere conduit for it to be held liable for the funds involved in the transfer.

[23] A party must have wielded dominion and control over the property being transferred in order to be liable. Johnston Law did not have possession or control over the funds, because the SURE monies went directly into an escrow account before it was transferred to Merlyn Grabanski per G&K/TFF' orders. [**Doc 328**].

[24] G&K/TFF deposited into the Johnston Law trust account $170,400 which occurred in two separate transactions dated October 14, 2011 and November 4, 2011. [**Doc 328**]. Upon instruction from G&K/TFF, $24,225.37 was removed from trust for Merlyn Grabanski as indemnification on behalf of G&K/TFF. *Id.* Johnston Law had no control over the funds that

were sent to Merlyn Grabanski, and Johnston Law was acting pursuant to its client G&K/TFF's instructions.

> **THE WITNESS:** Thank you, Judge. This just shows the checks that were made out to the trust account, deposited in the trust account. So it isn't payment to us, this money went from here, they deposited the money into our trust account and then instructed me from there.
>
> **THE COURT:** All right. Thank you. That's a clarification but in other words, not directly to the law firm but to the law firm trust account.
>
> **THE WITNESS:** Right.

[**App 212-213**].

[25] Under N.D.C.C § 13-02.1-08(2), a party may be liable for a transaction if the party was intended beneficiary of the transfer. The district court found the October 2011 transfer of $20,400 to Johnston Law was for the benefit of Merlyn Grabanski, the father of one of the G&K general partners. [**App 154**]. The transfer was not made for the benefit of Johnston Law, therefore Johnston Law could only be liable as the "first transferee" of the asset under the benefit theory.

[26] While no North Dakota case law defines initial transferee under the Uniform Fraudulent Transfer Act, many federal district courts have defined "initial transferee" liability under the similar 11 U.S.C. §550. "Considering the similarities in purpose and language, many courts have concluded that the UFTA and § 550 are in *pari material*, and that the same analysis applies under both laws." *In re: Sun Valley Products Inc.*, 328 B.R. 147, 155 (Bankr. D.N.D. 2005). As the

UFTA and § 550 are *pari material*, it is appropriate for decisional law construing either statute in this context to be used interchangeably.

[27] At least eight (8) different federal appellate circuits, the Eighth Circuit included, have held that an initial transferee can only be liable for a fraudulent transfer ***if*** the party maintained dominion or control over the property being transferred, and was not a "mere conduit" through which the transferred funds passed. *Luker v. Reeves (In re Reeves)*, 65 F.3d 670, 676 (8th Cir. 1995).

[28] Significantly, courts have defined control for the purposes of transferee liability as requiring "an unfettered legal right to use the funds for the possessor's own purposes and benefit." *Leonard v. First Commerce. Mortgage Co. (In re Circuit Alliance, Inc.)*, 228 B.R. 225, 232 (Bankr. 1998). Johnston Law was acting as an intermediary under the authority and direction of TFF/G&K.[1] Johnston Law did not have a legal interest in the funds and did not have authority to direct the funds to Johnston Law's own use. Johnston could not have acted contrary to his instructions without breaking his legal and ethical duty to his client.[2] Without dominion and control, Johnston cannot be liable as a first transferee.

[29] In *Leonard*, a Minnesota bankruptcy court found that a lawyer who had acted under the instructions of a client to transfer funds to a third party was ***not*** liable as a transferee. *Id*. The lawyer (Melcher) had a client (Hullerman) that was insolvent. *Id* at 229. In order to guarantee a

[1] "The October 2011 transfer of $20,400 to Johnston Law was for the benefit of Merlyn Grabanski ". [**App 154-155**].

[2] "Money belonging to the client or a third party must be held in a trust account. N.D.R. Prof. Conduct 1.15(a). Money belonging to the lawyer cannot be deposited in the trust account, except to pay certain banking fees. N.D.R. Prof. Conduct 1.15(b). "All property that is the property of clients or third persons, including potential clients, must be kept separate from the lawyer's business and personal property." N.D.R. Prof. Conduct 1.15 cmt. 1. *Disciplinary Bd. of the Supreme Ct. v. McDonagh (In re McDonagh*), 2013 ND 20, ¶14, 826 N.W.2d 622, 626 (N.D. 2013).

third party (Casey) followed through on his payment obligation, Hullerman instructed his lawyer to receive payment from Casey, to deposit that payment in the law firm's trust account, and to pay Hullerman through checks drawn on the trust account. *Id*. Hullerman's creditor then sought to have the transfer voided as a fraudulent transfer. *Id.* In the creditor's claim, the creditor sought recovery from the lawyer as a transferee. *Id*. at 232. The court found that the lawyer was ***not*** a transferee as Melcher did not receive a benefit from the transfer, nor did he exercise the requisite dominion or control. *Id*. at 233.

> "The uncontroverted evidence shows that, when Melcher received and then disbursed the funds from the Debtor, she was no more than the "mere conduit" envisioned by these cases: she was ***acting solely as an intermediary, without a legal interest in the funds*** and certainly without authority to direct them to her own uses. Holding the funds 'only for the purpose of fulfilling an instruction to make [them] available to someone else'." (*emphasis added*). *Id.*

[30] As occurred in *Leonard*, Johnston Law was "merely the conduit" for the disbursement. [**App 154**]. Johnston did not have a legal interest in the funds. Johnston did not have authority to direct the funds; Johnston Law held on to the funds as per client instructions, but Johnston Law did not control the funds. *Id.* The District Court made a finding of fact that the funds were always intended to be transferred to Merlyn Grabanski, and that Johnston Law had no control over the funds, stating, "(a)gain, they (Grabanskis) did retain control over the contemporaneous transfer to Merlyn Grabanski."[**App 159**]. As Johnston Law was merely a conduit in connection with the $24,225.37 transfer of funds and was not the initial transferee, Johnston Law cannot be liable to creditor PHI for that transfer.

II. The District Court erred when it voided a major portion of G&K/TFF's $145,774.63 payment to Johnston Law for attorney's fees and legal services despite finding Johnston Law was a good faith transferee which had provided reasonably equivalent value to the transferor in connection with the payment.

[31] The District Court made an error of law in its "Memorandum and Order for Judgment" when it voided a portion of G&K/TFF payment to Johnston Law. A good faith transferee which has provided reasonably equivalent value for a payment cannot have that payment voided by a court. *See*, N.D.C.C. § 13-02.1-08(1).

[32] The District Court found that Johnston Law was a good faith transferee that had provided the debtor reasonably equivalent value for the full $150,000 payment.[3] The "good faith" and "reasonably equivalent value" attributable to Johnston Law in connection with the $145,774.63 transfer constitute a total defense against the voiding of a fraudulent conveyance. [**App 158, 160**]. As a result, the District Court committed error, misapplying the law by voiding the major portion of that payment. Reduced to the essentials, given the District Court's findings that Johnston Law provided reasonably equivalent value and was a good faith transferee, no portion of the $145,774.63 payment could properly have been voided by the Court.

[33] Notwithstanding the District Court's factual findings that Johnston Law was a "good faith transferee" and had provided the debtor "reasonably equivalent value" for the full $150,000 payment -- the district court found that G&K/TFF acted with actual intent to defraud PHI by transferring money to Johnston Law, pursuant to subsection 1 of N.D.C.C. § 13-02.1-04.The Uniform Fraudulent Transfer Act (UFTA), through N.D.C.C. § 13-02.1-08, provides an affirmative defense, under which, "***a transfer or obligation is not voidable… against a person***

The proper amount of SURE payment money received by Johnston Law office for legal fees earned is $145,774.63. The Court mistakenly rounds the numbers to the amounts deposited into the Johnston Law Trust Account. [**Doc 328**].

who took in good faith and for a reasonably equivalent value." (*emphasis added*). N.D.C.C. § 13-02.1-08(1).

[34] G&K/TFF's payment to Johnston Law could only have been voided ***if*** Johnston Law had been either a bad faith transferee or if it had failed to provide reasonably equivalent value for the payment. The District Court made directly contrary findings, determining that Johnston Law actually was a "good faith transferee", and that the debtor had received "reasonably equivalent value" for the transfer. [**App 158, 160**].

[35] Indeed, the District Court specifically held that: "*;* "(w)hen all the surrounding circumstances are considered and evaluated, ***the debtor received reasonably equivalent value for the transfer of $150,000***."*[Id.];* and "I also find that ***Johnston Law was a good faith transferee.***" [**App 160**].

[36] Under these express findings of fact, Johnston Law satisfied the requirements of the affirmative defense N.D.C.C. § 13-02.1-08(1), whereby "***a transfer or obligation is not voidable… against a person who took in good faith and for a reasonably equivalent value***." Therefore, the District Court committed error by voiding any portion of the $145,774.63 payment.

[37] The District Court erroneously relied upon N.D.C.C. §13-02.1-08(4) – rather than the applicable affirmative defense within N.D.C.C. § 13-02.1-08(1) [4]. [**App 160**]. In contrast to N.D.C.C. §13-02.1-08(4), N.D.C.C. §13-02.1-08(1) of the UFTA provides a good faith transferee with markedly more protection.

[4] The defense under N.D.C.C. §13-02.1-08(4) is a less forgiving defense [*than that of N.D.C.C. §13-02.1-8(1)*] which derives from 11 U.S.C. § 548(c). Under N.D.C.C. §13-02.1-08(4), a transferee is provided an offset for actual value given. An N.D.C.C. §13-02.1-08(4) defense is appropriate where the party is a good faith transferee, ***but has not provided reasonably equivalent value for the transfer***.

> To the extent that reasonably equivalent value does not equal the value of the asset actually transferred by the transferee, a good faith transferee of an actual intent fraudulent transfer is afforded additional protection under Section 8(a) of the UFTA beyond that provided under Section 548(c) of the [United States Bankruptcy] Code.
>
> "*Revisiting the Proper Limits of Fraudulent Transfer Law*", 8 Bank. Dev. J. 55 at 111

[38] This vital distinction is also explained by the federal bankruptcy court in *Leonard v. Coolidge* (*In re Nat'l Audit Def. Network)*, 367 B.R. 207, 223 (Bkrtcy D. Nev. 2007), where the court distinguished the greater protection provided by UFTA Section 8(a) [correspondent to N.D.C.C. § 13-02.1-08(1)] as follows:

> Federal law avoids the entire transfer if it was made with the actual intent to hinder, delay or defraud, but it does give the transferee a lien on the property transferred to the extent of value given so long as the transferee took the property in good faith. 11 U.S.C. § 548(c).
>
> ***By contrast, Nevada law and the UFTA both give a recipient of an actual intent fraudulent transfer a complete defense to the extent that he or she took in good faith, and gave reasonably equivalent value for the exchange.*** NEV. REV. STAT. § 112.220(1) [correspondent to N.D.C.C. § 13-02.1-08(1)].
>
> 367 B.R. at 223

[39] "*Revisiting the Proper Limits of Fraudulent Transfer Law"* provides an example that distinguishes the protection offered under the UFTA Section 8(1) [North Dakota corollary N.D.C.C. § 13-02.1-08(1)] and Section 8(4) [North Dakota corollary N.D.C.C. §13-02.1-08(4)]:

> Suppose Aleph Corp. sold a horse worth $ 1,000,000 to Wilbur Post for $ 750,000. Subsequently, Aleph Corp… brought a fraudulent transfer action against Wilbur, arguing… Aleph Corp. received less than reasonably equivalent value while insolvent. Aleph Corp. also challenges the transfer as one made with the actual intent to hinder, delay, or defraud its creditors.
>
> At trial, the court concludes that the horse was worth $ 1,000,000; that Aleph Corp. was insolvent at the time of the transfer; that the $ 750,000 payment was an exchange for a reasonably equivalent value; and that the debtor, in fact, possessed the actual intent to hinder, delay, or defraud its creditors when it made the transfer. The proceedings then turn to the application of any affirmative defenses… under the UFTA or UFCA, Wilbur would have a complete defense; unfortunately, under the [Bankruptcy] Code, Wilbur would probably have to return the horse subject to a lien securing $ 750,000."

"*Revisiting the Proper Limits of Fraudulent Transfer Law*", 8 Bank. Dev. J. at 110-111

236 B.R. at 901

[40] The District Court determined that the transfer of $150,000 from G&K to Johnston Law was a fraudulent transfer. The District Court also found that Johnston Law had received the transfer for value and in good faith establishing the affirmative defense set forth in N.D.C.C. § 13-02.1-08(1). The affirmative defense prevents the transfer from being voided in whole or in part by the District Court. By failing to properly recognize and apply this affirmative defense of N.D.C.C. § 13-02.1-08(1), the District Court committed error in this respect.

III. The District Court committed error by holding that creditor PHI was not barred by the doctrine of *res judicata* from pursuing UCC Article 9 remedies to perfect a security interest in the subject funds after PHI had already obtained a money judgment relative to those funds.

[41] PHI attempted to improperly split its claim against G&K Farms by first obtaining a judgment then seeking Article 9 remedies. [**App 77- 90, 14**]. Res judicata bars PHI's attempts to enforce its security interest against G&K Farms and Johnston Law.

[42] The North Dakota Supreme Court explained in *Dakota Bank & Trust Co. v. Reed*, 402 N.W.2d 887, 890 (N.D. 1987), as it addressed former Uniform Commercial Code Section 9-501[5] [*formerly codified as N.C.C.C. Section 41-09-47*]:

> The secured creditor "may reduce his claim to judgment, foreclose or otherwise enforce the security interest by any available judicial procedure." Section 41-09-47(1) [9-501], N.D.C.C. J. White and R. Summers, Uniform Commercial Code 26-4, at p. 1091 (2d ed. 1980), summarize the two basic methods a secured party may use upon the debtor's default: ***First, he can seize the goods subject to his security interest and either keep***

[5] The provisions of former **U.C.C. Section 9-501** (*formerly codified at N.D.C.C. Section 41-09-47*) were reenacted in 2001 [*See, Engrossed House Bill 1105, S.L. 2001, ch. 361, Section 29*], when these provisions were re-codified within a re-configured Uniform Commercial Code as **U.C.C. Section 9-601**(***now codified at N.D.C.C. Section 41-09-98***). The Official Comments accompanying U.C.C. Section 9-601 make clear that the "source" for this latter statute is "(f)ormer Section 9-501 (1), (2) and (5)".

> ***them in satisfaction of the debt or resell them and apply the proceeds to the debt****. . . .* ***Alternatively, the creditor can ignore his security interest and obtain a judgment on the underlying obligation and proceed by execution and levy.*** (*emphasis added*).

402 N.W.2d at 890

[43] Referring to the *res judicata*-based holding in *Liberty Loan Corp. v. Wallace (In re Wilson)*, 390 F. Supp. 1121, 1121-1123 (D. Kan. 1975), the Comment accompanying former K.S.A. Section 84-9-501[*similarly re-codified as K.S.A. Section 84-****9-601***] explained as follows:

> ***Under the second and last sentences of this subsection*** [*former K.S.A. Section 84-9-501*], ***as well as subsection (2), the rights and remedies of the secured party are cumulative. Although*** the subsection indicates that the creditor could move against the collateral, obtain a personal judgment against the debtor, pursue any surety, or seek to enforce the obligation through any other means, in any order … ***there are limitations to the general rule of cumulative remedies… In re Wilson, 390 F. Supp. 1121 (D. Kan. 1975), holds that failure of a secured lender to seek judicial enforcement of an Article 9 security interest at the time it obtained a personal judgment against the debtor constituted an impermissible attempt to split a cause of action. Therefore, the lender was not allowed to seek judicial foreclosure on its secured claim when the debtor later filed bankruptcy.*** (*emphasis added*).

In *Liberty Loan Corp. v. Wallace (In re Wilson), supra*, the court explained as follows:

> In reaching the conclusion that Liberty Loan should be treated as a general unsecured creditor, the Referee decided two separate but interrelated questions. First, the Referee concluded that ***under the principles of res judicata, once Liberty Loan obtained a judgment on the debt without also bringing an action to replevin or foreclose on the collateral, Liberty Loan lost the right to assert its security interest in that collateral***. 390 F. Supp. at 1121-1123

[44] When Liberty Loan argued the subsequent enactment of U.C.C., K.S.A. 84-1 101 et seq., rejects the election of remedies doctrine, the court responded:

> ***Since the rights and remedies are cumulative, the creditor is not forced to elect between the remedies and thus is free to assert then simultaneously. It is the fact that he is free to assert them simultaneously which activates the res judicata doctrine.***
>
> ***Liberty Loan, having obtained an in personam judgment without asserting its security interest, is precluded, under the principles of res judicata, from bringing a subsequent action to enforce its security interest.*** *Id*.

[45] The Official Comments accompanying *current* U.C.C. Section 9-601 identifies the "source" for that statute is "(f)ormer Section 9-501 (1), (2) and (5)", it is compelling that, as these Official Comments further provide, relative to the subject of "Cumulative Remedies" of a

secured party under U.C.C. Section 9-601, "***(f)ormer 9-501(1) provided that the secured party's remedies were cumulative, but it did not explicitly provide whether the remedies could be exercised simultaneously. Subsection (c) [of U.C.C. Section 9-601] permits the simultaneous exercise of remedies if the secured party acts in good faith.***" (*emphasis added*).

[46] Not only did PHI reduce its claims against Thomas Grabanski and G & K Farms to a money judgment in a federal district court civil action back in March of 2011 – but PHI also expressly declined to exercise its exercise its Uniform Commercial Code Article 9 rights – several months before the SURE payments were received by G & K Farms in October of 2011. North Dakota Federal District Court Case No. 2:10-cv-28; [**App 77-90**]. Under the rationale of the federal district court in *Liberty Loan Corp. v. Wallace (In re Wilson), supra,* PHI lost its security interest in the SURE payment when PHI obtained a judgment in North Dakota Federal District Court Case No. 2:10-cv-28 under the application of *res judicata*.

IV. Did the District Court commit error by holding that the doctrine of res judicata determined that PHI held a perfected security interest in the funds received by Johnston Law Office from the SURE payment for legal services.

[47] The District Court, in its Memorandum and Order for Judgment, relied upon PHI's financing statement in concluding that PHI ***perfected*** its ***attached*** security interest in the transferred funds. [**App 152, Trial Transcript at pg. 52**].[6] The court makes no mention of the

[6] Unfortunately, the court confused the related doctrines of *res judicata* with the of issue preclusion of collateral estoppel. [**App 68, 69**]. ***Because the United States District Court did not address the subject of whether PHI's security interest had been perfected in its order, Johnston Law should not have been barred from raising this issue in the instant case***, and the District Court committed error by holding to the contrary.

The North Dakota Supreme Court delineated the distinction between the doctrines of "*res judicata*", or *claim preclusion,* and "collateral estoppel", or "issue preclusion", as follows, in *Riverwood Commercial Park, LLC, et. al., v. Standard Oil Company, Inc., et. al.*, 2007 ND 36, ¶ ¶ 13-14, 729 N.W.2d 101, 106-107 (N.D. 2007):

doctrine of res judicata in the court's final Order, though the court did find the doctrine applicable to the issue of perfection in its Order denying Johnston Law's Motion to Bifurcate. [**App 68, 69**]. The doctrine of res judicata, if it was applied in the court's ruling, is inapplicable to the issue of perfection.

[48] Johnston Law filed a motion to bifurcate the trial to reach a resolution on the threshold perfection issue. [**App 45-51**]. Johnston Law requested that the District Court first try and decide the issue of whether PHI even had "a perfected security interest in the disputed SURE payment" because determination of that issue in Johnston Law's favor would have made trial on the remaining issues unnecessary.

[49] The District Court denied Johnston Law's Motion Bifurcate, holding as follows:

> "Unfortunately for Johnston Law, a Federal District court has already decided the issue, finding PHI to have perfected security in 'government payments . . . and all proceeds of the foregoing." [**App 68-69**].

[50] In order to enforce its security interest in the SURE payment against third party creditors – *such as Johnston Law* -- PHI needed a ***perfected*** security interest in these funds. The priority of a security interest is determined by the date of perfection, – in relation to the respective dates upon which putatively competing security interests were perfected. Correspondingly, if a

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Claim preclusion or issue preclusion in a subsequent action is governed by *res judicata* and collateral estoppel. "Although collateral estoppel is a branch of the broader law of *res judicata*, the doctrines are not the same." *Res judicata*, or claim preclusion, prevents re-litigation of claims that were raised, or could have been raised, in prior actions between the same parties or their privies… Collateral estoppel, or issue preclusion, forecloses re-litigation of issues of either fact or law in a second action based on a different claim, ***which were necessarily litigated, or by logical and necessary implication must have been litigated, and decided in the prior action.*** *Ungar v. North Dakota State Univ., 2006 ND 185, PP10-11, 721 N.W.2d 16* (*citations omitted*); *see Witzke v. City of Bismarck, 2006 ND 160, P8, 718 N.W.2d 586*; *Simpson v. Chicago Pneumatic Tool Co., 2005 ND 55, P8, 693 N.W.2d 612*; *Cridland v. North Dakota Workers Comp. Bureau, 1997 ND 223, PP14 and 17, 571 N.W.2d 351*. (*emphasis added*).

2007 ND 36, at ¶ ¶ 13-14, 729 N.W.2d at 106-107

security interest remains *unperfected*, every other creditor with a *perfected* security interest has priority over the non-perfected security interest. *Thompson v. Danner*, 507 N.W.2d 550, 554-555 (N.D. 1993).

[51] The issue of whether PHI's *attached* interest had been *perfected* is not a claim, but rather is an issue of fact and law, coming within the purview of the doctrine of collateral estoppel, and not the more general doctrine of *res judicata*. *Id.*

[52] The issue of perfection of PHI's security interest could only have been properly barred from consideration if that question had been ***litigated and decided*** in a prior action. For the issue to have been barred from consideration, the United States District Court would have had to have actually addressed the issue of perfection of PHI's security interest, or the resolution of issue of perfection of PHI's security interest in the subject funds must have had logical and necessary implication from the federal court's orders.

[53] The subject federal court decisions of the Honorable Ralph Erickson did not address the subject of "perfection" of any security interest in favor of current plaintiff PHI Financial Services, Inc. [**App 77-90].**

[54] Conversely, the federal court ***did*** refer to "the plain language of the ***loan agreement*** and ***separate security agreement***", concluding that as a result of substance of these two documents, "***PHI holds a security interest*** in certain assets of the Grabanski defendants . . . ." *Id.* The analysis of the loan agreement and separate security agreement indicates that ***the court was only interested in determining the validity of PHI's attached security interest – not whether that security interest had been PERFECTED.*** *Id. See, also, Footnote 6, supra, and Thompson v. Danner, supra, 507 N.W.2d at 554-555.*

[55] Whether PHI attached a security interest to G&K Farms' assets is a separate question from "***perfection***". The federal district court only determined that PHI has an *attached* security interest in G&K property. As no other third party creditor was involved in that federal court action, the federal district court had no need to address the issue of perfection of the security interest.

[56] The North Dakota Supreme Court delineated the distinction between security interest "attachment" and security interest "perfection" in *Thompson v. Danner*, *supra*, 507 N.W.2d at 554-555, as the Court explained:

> ***The creation of a perfected security interest is accomplished by a two-step process: attachment and perfection***. *See N.D.C.C. § 41-09-24* [U.C.C. § 9-303]. ***While "attachment" relates to the creation and enforceability of a security interest between the parties to the transaction, "perfection" is an additional step which makes the security interest effective against third parties.*** *Citizens Nat. Bank of Evansville v. Wedel, 489 N.E.2d 1203, 1205 (Ind. Ct. App. 1986).* ***A creditor perfects a security interest in crops to be grown by filing an appropriate financing statement.*** *N.D.C.C. § 41-09-23(1)* [U.C.C. § 9-302]. (*emphasis added*).
>
> 507 N.W.2d at 554-555

[57] The federal district court's order filed May 30, 2012 addressed the circumstances of an "attached" security interest as to the Grabanski defendants in that action. [**App 77-90**]. The federal district court never addressed the issue of whether PHI's "attached" security interest had been "perfected" as to the SURE payments. *Id*. As the issue was never previously addressed, Johnston Law cannot be barred by the District Court from addressing the issue in this case, the District Court's reliance upon on doctrine of *res judicata* was error, and the decision on this issue should be reversed and vacated.

V. PHI failed to perfect its security interest in G&K's collateral because the financing statement filed by PHI contained legally deficient descriptions of the collateral.

[58] If the Court determines that the issue of perfection is not precluded by res judicata and finds in favor of the district court's ruling for fraudulent transfer, the issue of perfection will need to be resolved. If PHI did not have a perfected security interest, PHI would not have priority over Johnston Law as a fellow creditor.

[59] Iowa state law governs the Security Agreement between PHI and G&K. The Security Agreement provides, in pertinent part:

> ***Governing Laws and Venue: The laws of the State of Iowa will govern thisAgreement and collection of amounts due under it*** . . . (*emphasis added*). [**App 62**].

In the absence of Iowa law, Texas law would govern perfection of Texas crops, or payments deriving from Texas crops pursuant to N.D.C.C. § 41-09-21(2).

[60] PHI was required to file a proper financing statement to perfect its security interest. N.D.C.C. § 41-09-30. Perfection requires an adequate description of the collateral in the financing statement. N.D.C.C. § 41-09-08. The money that G&K transferred to Johnston Law derived from the SURE payment, an insurance payment on Texas crops. In order to *perfect* its security interest, PHI's financing statement must have included an adequate description of the Texas crops.

[61] Significantly, PHI's financing statement designated only counties located within the State of North Dakota, but failed to include any out-of-state counties. In particular, while PHI specifically references five North Dakota counties in its financing statement, PHI fails to designate "County Code 54" on the document – which refers to counties located outside of the State of North Dakota. [**App 52-52**].

[62] Neither Iowa nor Texas Code requires the financing statement to include an exact location of crops in order to perfect the security interest. However, there are perils for a lender who describes collateral with great specificity – while omitting reference entirely in that same financing statement to the locations of other intendedly-secured collateral.

[63] In *First National Bank in Creston v. Francis*, 342 N.W.2d 468, 470-471 (Iowa 1984), the Iowa Supreme Court addressed a situation in which a lender loaned money to a farmer for his farming operations, and provided on the financing statement a very specific – *yet erroneous* -- description of the land upon which the growing crops (*and proceeds*) intended to be collateral for the loan were located.

[64] The Court in *First National Bank in Creston v. Francis, supra,* explained:

> Our decision must turn not on whether the description was sufficient to secure crops but ***whether it was so specific that it could only reasonably be read to secure the crops on the described land***. We agree with the trial court's conclusion that the bank's erroneous specific description was "seriously misleading" and did not encumber the crops which the cooperative purchased.
>
> Nothing in the bank's description would have caused the cooperative or some other person checking the record to suspect the section number was wrong or that the bank intended to encumber crops on other land... The purpose of the Code's description requirements for financing statements is to give notice to purchasers and third-party creditors and allow them to identify what property is secured. J. White & R. Summers, *Handbook of the Law Under the Uniform Commercial Code* § 23-16, at 964 (2d ed. 1980)….
>
> When, as here, nothing in the instrument itself indicates or directs that further inquiry should be made concerning the location of the secured crops, the third person need not make further inquiry. ***The bank can point to nothing within the financing statement or security agreement which would have alerted third persons that the bank had made a mistake and in fact intended to cover crops other than those at the specified location***…
>
> A third person noting that somewhat indefinite description would have been put on further inquiry to learn precisely what crops were encumbered. 311 F.Supp. at 285-86**.** ***Here, in contrast, the cooperative was not put on further inquiry because the description itself specifically defined and delineated the location of encumbered crops*****.**" (*emphasis added*) 342 N.W.2d at 470-471.

[65] PHI's financing statement description clearly delineated – in greater detail than necessary -- the land locations for the growing crops (and proceeds) which the financing statement designated, upon its face, as collateral. [**App 52-54**].

[66] However, like the lender in *First National Bank in Creston v. Francis, supra*, due to this very specificity, a third party objectively would not have been put on notice to conduct further inquiry because the financing statement defined and delineated the location of the apparently-encumbered crops.

[67] Looking at the remainder of the document, the reasonable conclusion is that *only North Dakota crops* were meant to be included as secured collateral. On the second page, under G&K Farms, PHI included neither descriptions of property nor any county codes. [**App 53**]. A reasonably prudent third party would believe that that intentional act signified that PHI had no security interest in G&K Farms' Texas crops or proceeds thereof. [**Trial Transcript at 53-54**].

[68] Finally, any remaining suspicions were satisfied by the collateral description on page one. In that latter description, PHI designated "all the debtor's…", signifying that only one debtor had collateral upon which PHI was perfecting a security interest. [**App 52**].

[69] As the United States Bankruptcy Court for the District of North Dakota explained in *Nelson v. United States*, 45 B.R. 443, 445 (Bkrtcy. D.N.D. 1984), a case which cited with approval *First National Bank in Creston v. Francis, supra*:

> The subject financing statements have been read in light of the liberal interpretations given to section 41-09-10 of the N.D.C.C. and ***whether there is anything on the face of the financing statement suggesting that the CCC made an error or that additional grain may be covered. If neither of these possibilities are suggested from the face of the financing statement, then no further inquiry is necessary and the financing statements are insufficient.*** (*emphasis added*).
>
> 45 B.R. at 445

[70] PHI's specificity in its financing statement, coupled with its omissions and misrepresentations, created a situation where the description no longer satisfies the standard of reasonable description of the collateral. As the bankruptcy court added in *Nelson v. United States, supra*:

> Although greater specificity is not required, the U.C.C. does not prohibit a creditor from providing as much detail as it may wish, and a financing statement may be very specific. ***Specificity is not without risk, however, because if the description is erroneous it may be so misleading as to cause a person to completely rely upon it without the suggestion that any additional inquiry should be made.*** *Id*. (*emphasis added*).
>
> 45 B.R. at 444-445

[71] Due to PHI's specificity, the omissions resulted in far greater confusion then under ordinary standards. As such, PHI has filed a financing statement that is seriously misleading and that does not adequately identify the collateral, at least to the crops in Texas from which the SURE payment derives. Since PHI does not have a financing statement which adequately describes the collateral, PHI's interest – ***albeit attached*** – ***was nevertheless not perfected*** and thus does not have priority over Johnston Law's interest in the funds paid to it by G & K Farms for legal fees.

VI. The District Court erred in its calculation of pre-judgment interest as PHI's right to recovery did not vest on the date of the transfer.

[72] The District Court ordered pre-judgment interest, calculating the total interest from date of G&K/TFF's transfer to Johnston Law Office. [**App 152-161**]. N.D.C.C. § 32-03-05 allows for pre-judgment interest to be granted upon discretion of the court. However, pre-judgment interest cannot be granted prior to the date of vested right of recovery. *See Midland Diesel Serv. & Engine Co. v. Sivertson*, 307 N.W.2d 555 (N.D. 1981). Because PHI did not have a vested right of recovery on the date of transfer, pre-judgment interest could not accrue on that date.

[73] In fraudulent transfer cases, pre-judgment interest will begin to accrue from the time demand is made or an adversary proceeding is instituted. *See e.g. Miller v. Dow* (*In re Lexington Oil & Gas Ltd.*), 423 B.R. 353, 376-377 (Bankr. E.D. Okla. 2010), *Floyd v. Option Mortg. Corp.* (*In re Supplement Spot, LLC*), 409 B.R. 187, 210 (Bankr. S.D. Tex. 2009). April 17, 2012, the date PHI filed its complaint, is the soonest pre-judgment interest could accrue. [**App 14**].

[74] However, as PHI's right to recovery was disputed by Choice Financial, who also claimed a security interest in the SURE payment, the right to recovery did not vest until after the complaint was filed. The District Court ruled on summary judgment that PHI has priority over Choice, however Choice has appealed on the issue of priority and Johnston Law challenges whether PHI ever perfected its security interest. PHI's right to recovery is still in dispute and did not vest at least until the Court ordered summary judgment on the issue of priority.

[75] The court erred in calculating pre-judgment interest beginning on the date of the transfer (October, 2011). Accrual should not have been calculated until a much later date, at the very soonest April 7, 2012, the date PHI filed its complaint.

CONCLUSION

[76] The district court erred in attributing liability to Johnston Law for the $20,400[7] indemnity payment which was made from the Johnston law IOLTA trust account to Merlyn Grabanski. A party may only be liable as a transferee if that party maintained control or dominion over the property, and because the district court found that Johnston Law acted only as a "conduit" for payment of those funds to Merlyn Grabanski, the District Court committed error in holding Johnston Law liable to PHI for those funds.

[7] The District Court erroneously used the amounts deposited into the trust account as the split of funds between Merlyn Grabanski and Johnston Law.

[77] The District Court also committed error by voiding a significant portion of G&K/TFF's $150,000 payment to Johnston Law for attorney's fees/legal services. Payments to good faith transferees for reasonably equivalent value may not be voided. The District Court findings of fact that: (1) Johnston Law was a "good faith transferee" in connection its receipt of these funds; and (2) that the debtor had received "reasonably equivalent value" for that payment. Under these circumstances, the District Court committed error by voiding a substantial portion of the $150,000 payment to Johnston Law for attorney's fees and legal services.

[78] Alternatively, the District Court committed error by offensively applying the doctrine of *res judicata* to preclude Johnston Law from questioning the perfected status of PHI's security interest. Because the doctrine of collateral estoppel may only be used to deny re-litigation of a claim which has already been addressed in a prior proceeding, and because the issue of perfection of PHI's security interest had not been addressed in prior litigation, Johnston Law could not be precluded from raising the question of whether PHI had perfected its attached security interest in the SURE payment.

[79] Finally, PHI failed to perfect its attached security interest in the SURE payment funds which are at issue in the instant case, and the Supreme Court may and should make a finding to this effect in this appeal.

[80] This court should reverse the judgment of the District Court.

Dated this 19th day of May, 2015.

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In the Supreme Court
State Of North Dakota

May 14, 2015

Supreme Court No. 20150008

PHI Financial Services, Inc.,

Plaintiff, Appellee and Cross-Appellant,

v.

Johnston Law Office, P.C.,

Defendant, Appellant, and Cross-Appellee

Choice Financial Group,

Defendant, Appellee and Cross-Appellant.

Supreme Court No. 20150008

Grand Forks County Number: 18-2012-CV-00577

CERTIFICATE OF ELECTRONIC SERVICE

I, **DeWayne Johnston**, attorney for the Defendant\Appellant, and officer of the court, hereby certify that a true and correct copy of the foregoing:

1. **Initial Brief of Appellant; and**
2. **Appellant's Appendix**

were served via **ELECTRONIC MAIL** from Grand Forks, North Dakota on this 14th day of May, 2015 to:

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I, **DeWayne Johnston**, attorney for the Defendant\Appellant, and officer of the court, hereby certify that a true and correct copy of the foregoing:

1. **Initial Brief of Appellant;**

were served via **ELECTRONIC MAIL** from Grand Forks, North Dakota on this 19th day of May, 2015 to:

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