UNITED STATES BANKRUPTCY COURT

IN AND FOR THE DISTRICT OF ARIZONA

In re COVENANT CHRISTIAN CENTER INTERNATIONAL, INC., **Debtor.**	**Chapter 11 Proceedings** **Case No. 2-06-02386-PHX-CGC** **Adv. No. 07-55**
COVENANT CHRISTIAN CENTER INTERNATIONAL, INC., **Plaintiff,** **v.** **MORTGAGES, LTD., MORTGAGES LTD. SECURITIES, LLC, and NEW HOPE PARTNERS, LLC,** **Defendants.**	**UNDER ADVISEMENT DECISION RE: MOTION TO DISMISS**

I. Introduction

At issue is the motion to dismiss Plaintiff Covenant Christian Center International, Inc.'s ("CCCI") First Amended Complaint filed by Defendants New Hope Partners, LLC ("New Hope") and Mortgages Ltd. ("ML") (collectively referred to as "Defendants").[1] The motion was argued and submitted on May 30, 2007.

II. Factual Background

This matter has been the subject of numerous hearings and two contested stay relief trials, each of which has resulted in written decisions by the Court reciting the basic facts of the transactions at issue. For the purpose of this memorandum decision, the Court will restate those facts briefly. None of the facts stated as such are in serious dispute; any allegations that are

[1]Except as otherwise noted, to the extent matters are considered that are outside the four corners of the complaint, the motion will be treated as one for summary judgment.

disputed will be identified as such.

In March, 2005, ML lent Debtor CCCI $1,075,000 on an interest only basis for one year at the rate of 11.5%,[2] funding the loan out of investor pools. ML and CCCI entered into a Servicing Agreement that provided for provision of certain services by ML and the payment of certain fees by CCCI. The loan matured on March 4, 2006, without payment by CCCI of the principal sum then due. CCCI alleges that "[p]rior to maturity, [CCCI] had been told that [ML] would agree to an extension of the [CCCI] Loan past the March 4, 2006 date if [CCCI] would pay additional monthly payments of interest while take-out financing was located."[3]

However, upon default, ML arranged the sale of the loan from the existing investors to New Hope pursuant to the "Performance Plus Program" ("PPP"). Under the PPP, New Hope was required to advance sufficient funds to cash out all of the existing investors and bring current any delinquent interest, late charges and past due taxes. In addition, it paid certain fees and expenses to ML and entered into a contract with ML pursuant to which ML acted as its servicing agent. Upon default, the loan documents provided for default interest of 27%[4]; pursuant to the PPP, New Hope was entitled to receive the first 18% of the default interest and ML was entitled to the remaining 9%. In addition, ML was entitled to receive any other fees due from CCCI, including, for example, late charges,[5] maturity late charges,[6] administrative fees, and the like. The terms of the PPP were not disclosed to CCCI either before or after maturity, other than as part of discovery in this bankruptcy case. Following maturity, ML took steps to commence a trustee's sale as the agent of New Hope. ML twice agreed to postpone the trustee's sale a total of thirty-four days upon payment of two extension fees totaling $32,250, which amounts were retained by ML. When a refinance did not occur and the trustee's sale was

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[2]Note ¶ 2.

[3]First Amended Complaint, ¶ 25.

[4]Note ¶ 7(g).

[5]Late charges accrued at the rate of 35% of the monthly payment due. Note ¶ 6(a).

[6]Maturity late charges were charged at the monthly rate of 3% on the unpaid principal amount after maturity. Note ¶ 6(a).

imminent, CCCI filed this case.

III. Analysis

A. <u>First Claim for Relief–Breach of the Duty of Good Faith against ML</u>

CCCI alleges that ML's "acts, including misrepresentations and concealment of [ML's] true role . . . in the Covenant Loan relationship, constitute breaches and violations" of ML's duty of good faith and fair dealing. ML has moved to dismiss this count on the ground that the implied covenant of good faith and fair dealing cannot be used to prohibit a party from exercising its express contractual rights.

The Supreme Court of Arizona has thoroughly explained the applicable law on the good faith covenant in *Wells Fargo Bank v. Arizona Laborers, Teamsters and Cement Masons Local No. 395 Pension Trust Fund*, 201 Ariz. 474, 38 P.3d 12 (2002). To begin, the law implies a covenant of good faith and fair dealing in every contract. The covenant "prohibits a party from doing anything to prevent other parties to the contract from receiving the benefits and entitlements of the agreement." 38 P.3d at 28. On the other hand, "the duty to act in good faith does not alter the specific obligation of the parties under contract. . . . Acts in accord with the terms of one's contract cannot *without more* be equated with bad faith." 38 P.3d at 30 (citing *Southwest Savings & Loan Assoc. v. SunAmp Sys., Inc*., 172 Ariz 553, 558, 838 P.2d 1314, 1319 (App. 1992) (emphasis in original)). Putting these two concepts together, *Wells Fargo* gives us the following roadmap to analyzing the first claim for relief in this case in a light most favorable to CCCI:

> The key questions are:
>
> (1) were [ML's] actions inconsistent with what [CCCI] justifiably expected under the [loan agreements]?
>
> (2) did [ML], by its action or inaction, deprive [CCCI] of a primary benefit of the agreement . . .?
>
> (3) was it reasonable for [CCCI] to assume [ML] would [act in a neutral way in its varied roles under the various loan documents, despite ML's self interest that derived from its right to receive additional compensation as a result of default]?
>
> (4) was it reasonable for [CCCI] to assume, despite its self interest, that ML would

> disclose the existence of the PPP to CCCI and how it might change the dynamics of the loan relationship?

38 P.2d at 31.

The essence of CCCI's claim is that, despite its obligations to CCCI as a mortgage broker and under the Servicing Agreement, ML had an undisclosed profit based incentive not to "work with" CCCI when it was unable to pay the loan on maturity but rather to facilitate or encourage a default. In contrast, ML's position is that all it did after default was exercise its remedies under the loan documents and that such actions cannot, as a matter of law, be a breach of the covenant of good faith and fair dealing.

The difficulty with CCCI's case is that it acknowledges that it defaulted under the loan documents by failing to pay the debt when it matured. It is clear that, had the loan been paid when due, the payoff amount would not have included any PPP related amounts as the sale to New Hope did not occur until after maturity. So the question becomes, what were CCCI's justifiable expectations of how ML would perform its contractual obligations *post-default* and what was the primary benefit of the agreement of which CCCI was deprived because of ML's action or inaction?

CCCI suggests several things in this regard. First, it alleges that although ML represented that the maturity would be extended on a month to month basis if regular interest payments were made, it instead moved immediately after default to sell the loan to New Hope under the PPP and push the loan into collection, thereby vastly increasing the amount owed. Second, it alleges that ML engaged in a scheme to run up the balance on the loan to make refinancing impossible, thereby enabling it to receive the benefit of 9% back end interest payment, as well as the collection of various fees. Third, it suggests that ML had a pre-default plan to resell the loan under the PPP, which it concealed from CCCI, that would yield to it a far greater return than what would have been realized under the sale agreements with the previous investors. In other words, even though the loan documents did disclose the potential of 27% default interest that would be payable after maturity by CCCI, it did not disclose that 9% of that amount would be paid to ML and not the investor who owned the loan. CCCI's claim is that ML had the duty to be an "honest broker," which it was in fact not because of the concealed 9% back end interest. Central to CCCI's claim is that ML should have been neutral on whether the loan was in default or not (having sold the economic interests in the loan to third parties) but in fact was not because of its concealed financial interest.

Framed in this way, CCCI has a difficult road ahead. Although not an impossible claim to prove, CCCI will have to prove that ML acted with bad intent and/or pursuant to a pre-conceived scheme in pursuing its contractual remedies after CCCI's default, a default that CCCI admits occurred by way of its actions alone and not by any action of ML. At this stage of the case, CCCI has not produced any evidence of such intent; rather, all we have is counsel's presumptions as to what ML's intent must have been. However, on a motion to dismiss, this Court must decide the issue solely upon a reading of the complaint in the manner most favorable to the plaintiff.[7] If, for example, CCCI were able to prove the existence of a pre-default scheme to run up the debt, the conscious concealment of the PPP as a means of gaining an unfair economic advantage over CCCI, or a representation that the loan maturity would be extended and the status quo maintained by the payment of regular pre-default interest (while, in fact, always intending to immediately sell the loan under the PPP), then a finder of fact could determine that the good faith covenant had been breached under Arizona law, notwithstanding CCCI's uncontested failure to pay the debt when due. Arriving at this result will be difficult because of CCCI's own failure to abide by its contractual promises, but it is not precluded as a matter of law.

For the foregoing reasons, the motion to dismiss the first claim for relief is denied.

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[7]ML suggests that the motion to dismiss this claim should be decided as a motion for summary judgment to the extent that matters outside the four corners of the pleadings are considered. Although that is appropriate for some of the other claims in the Complaint, it is not appropriate for this claim. The difficulty is that ML, as the moving party, is not put to the usual burden of preparing and supporting a statement of facts and that CCCI is therefore precluded from some of its usual defenses, including the invocation of Rule 56(f).

B. Second Claim for Relief: Arizona Revised Statute ("A.R.S.") § 33-404 against ML

A.R.S. § 33-404 requires that if an interest in real property is conveyed to a grantee who is described as or acts as a trustee, the beneficiaries of the trust must be identified and disclosed in a recorded document. CCCI argues that ML has failed to comply with this statute by not recording a document showing its right to receive the 9% in back-end interest under the Loan Sale agreement with New Hope.

This count is flawed and must be dismissed. First, the language of the statute would seemingly require a finding, first, that ML, as grantor, conveyed to New Hope, as grantee, an interest in property through the assignment of the deed of trust and, second, that New Hope was acting as a trustee under a trust in which ML held a beneficial interest. CCCI's complaint does not even allege this to be true.[8] All the complaint alleges is that at the time of the recordation of the assignment of beneficial interests to New Hope, ML held a "significant beneficial interest." In this case, for example, there is no basis upon which ML could foreclose on the property to be paid its 9%. Notwithstanding CCCI's arguments to the contrary, there is no basis to conclude that ML has an undisclosed interest in the real property through a deed of trust or otherwise. ML has a contractual right to collect the additional 9% interest from New Hope (and, as the servicing agent, is in a position to pay itself if there is sufficient recovery), but there is no assignment of any interest in the real property, a key fact in triggering the operation of Section 33-404. CCCI's claim is a round peg that does not fit in the square hole of this statute.

In addition, the statute is clear and the courts have confirmed that the exclusive remedy if the statute is breached is an action by the other party to the transaction.[9] CCCI argues that it is a

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[8]Perhaps another iteration would be that the Loan Sale agreement was the transfer of an interest in property from New Hope to ML; but, there is no language in that agreement to suggest that it is a "deed or conveyance of real property."

[9]CCCI's reliance on the dissent in *Blalak v. Mid-Valley Transportation, Inc.*, 858 P.2d 683 (App. 1993), for the contrary view is disingenuous, at best. The majority opinion says that it is "crystal clear" that the remedy under Section 33-404(E) is exclusive.

party to the transaction because it is a party to the deed of trust. But, the conveyance at issue is not the deed of trust but the assignment, to which it is not a party.

For the foregoing reasons, the second claim for relief will be dismissed.

C. Third Claim for Relief – Avoidance action against ML

The third claim for relief is that the transfer of the beneficial interests to ML are avoidable under Section 544 and recoverable under Sections 550 and 551. But, as made clear above, there was no transfer of a beneficial interest to ML. Therefore, this claim shall also be dismissed.

D. Fourth Claim for Relief – A.R.S. § 6-947 against ML

The fourth claim for relief is based upon A.R.S. § 6-947(D), which provides in relevant part:

> A person engaged in the mortgage banking business shall not knowingly advertise, . . . distribute . . . in any manner whatever, any false, misleading or deceptive statement or representation with regard to the rates, terms or conditions for a mortgage banking loan or mortgage loan. The charges or rates of charge, if stated, shall be set forth in a clear and concise manner.

ML moves to dismiss on two grounds: first, that the complaint does not allege "false advertising," which, it argues, is the entire scope of the statute; and second, that if the statute does apply, the fact is that it has complied with it.

As is clear from the redacted version set forth above, the statute's reach is not limited to advertising but includes any "distribution" of information about rates and fees. It is undisputed that such distribution occurred in this case. Whether the information was distributed "clearly and concisely" is a question of fact not to be determined on a motion to dismiss. Therefore, the motion to dismiss the fourth claim for relief will be denied.[10]

E. Fifth Claim for Relief – Disallowance of ML claim

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[10]ML correctly notes that non-compliance with Section 6-947 does not affect the validity of the loan. By implication, the relief available is the recovery of damages. As the Court reads the relief requested in the complaint, it is limited only to damages against ML or disallowance of any payment from New Hope to ML under the Loan Sale agreement and does not seek invalidation of the loan in the hands of New Hope.

The fifth claim for relief is to disallow any claim filed by ML. ML has not filed a claim and has stated its intention not to do so. The bar date has passed. Therefore, this claim will be dismissed as moot.

F. Sixth Claim for Relief – Disallowance of New Hope Claim

The sixth claim for relief is to disallow the claim of New Hope for "unenforceable loan charges, fees, expenses and/or interest." There is sufficient detail provided for these allegations to survive a motion to dismiss. This is without prejudice to a fact-based dispositive motion or determination on the merits. At oral argument, CCCI suggested that New Hope's claim should be reduced by the amounts claimed within it that are earmarked for ML. This issue will be addressed in due time upon an adequate factual record. Therefore, the motion to dismiss the sixth claim for relief will be denied.

G. Seventh Claim for Relief – Equitable subordination against ML, ML Securities and New Hope

This is a claim for equitable subordination under Section 510(c). ML is correct that such claims require "gross and egregious conduct" in order to succeed. These are highly fact intensive cases where the debtor must show that inequitable conduct by one creditor has damaged the interests of other creditors such that it would be equitable to subordinate the wrongdoer's claim to the claims of other creditors.

Of course, only claims asserted against the estate are subject to subordination under Section 510(c). As noted above, ML has filed no such claim and the docket reflects the same for ML Securities. Therefore, the seventh claim for relief as against those parties should be dismissed. In this vein, counsel for CCCI stated at oral argument that its equitable subordination claim (even though not originally pled in this way) was limited to that part of the New Hope claim representing amounts due to ML over and above the principal and 18% interest payable to New Hope (to the extent such claim is allowed). In other words, the Court understands that the equitable subordination claim against New Hope has been abandoned except to the extent that such claim includes amounts payable under the PPP by New Hope to ML.

It is unusual, at the least, for a debtor to seek equitable subordination of a portion of a creditor's claim based not on that creditor's actions, but on the basis of the actions of a third party not asserting a claim against the estate. Even though the Court has already held that the good faith covenant claim *against ML* is sufficient to survive a motion to dismiss, that does not lead to the conclusion that any portion of *New Hope's claim* would then be subject to subordination. To do so would not be equitable as to New Hope, which undeniably advanced good and valuable consideration for the purchase of the loan from ML. In addition, the third prong of an equitable subordination case is that granting relief would be consistent with the Bankruptcy Code. The Court concludes, as a matter of law, that it would not be consistent with the claims allowance scheme of the Code to equitably subordinate a creditor's claim based not on that creditor's actions but on the actions of another. As further noted at oral argument, this claim is separate from CCCI's sixth claim for relief, which seeks disallowance of portions of the New Hope claim that, if successful, would have a similar practical effect as the relief sought here. Under the unusual facts of this case, therefore, the Court will dismiss the equitable subordination claims in their entirety against all three defendants for the reasons stated.

H. <u>Eighth Claim for Relief – Preference Recovery against ML</u>

This claim alleges that the extension fees paid by CCCI to ML in connection with postponing the trustee's sale are recoverable as preferences.

Section 547(b) requires that, to be avoidable as a preference, a pre-petition payment must be made to or for the benefit of a creditor, made while the debtor was insolvent, for or on account of an antecedent debt that resulted in the creditor receiving more than it would have received had the payment not been made and the debtor had been subject to a hypothetical Chapter 7 liquidation. ML argues, first, that CCCI cannot make this *prima facie* case, but that, if it can, it has defenses that would preclude recovery.

On June 23, 2006, ML, as agent for New Hope, and CCCI entered into an agreement extending the pending trustee's sale from June 27 until July 6, 2006. For this extension, a fee of 1.5% of the principal balance, or $16,250, was incurred, but not paid, by CCCI and added to its debt to New Hope. Later, on June 30, 2006, ML, as agent for New Hope, and CCCI entered into a second agreement, this time extending the trustee's sale from July 6, 2006, until a date after July 31, 2006. This agreement required that an additional fee of $32,250 (3% of the principal amount) be paid no later than July 17, 2006, for the extension until the date after July 31. This amount was paid by two cashier's checks, one received as of June 30 and the other received on July 17.

Under the loan documents, all fees are part of the debt owed by CCCI to New Hope, but ML is entitled to retain such fees as "compensation" for its services under its PPP agreement with New Hope.[11] The documents reflect that no payment was made on account of the initial 1.5% extension fee and that it remains part of the debt today; therefore, there can be no preference as to this amount. The issue, then, is whether a claim may be stated that the payment by two cashier's checks for the second 3% fee was made to a creditor, on account of an antecedent debt, when the debtor was insolvent, and resulted in the creditor receiving more than in a hypothetical liquidation.

The answer is that, while such a *prima facie* case may be stated, the First Amended Complaint as drafted does not state one. The Complaint states that the payment was made to ML and that it was the creditor that received more than it would have in a hypothetical liquidation. But it was not the creditor; New Hope was. As the obligation to make the payment apparently arose out of the June 30 agreement, and final payment was made on July 17, it is possible to state a claim that the payment made on July 17 was on account of an antecedent debt incurred 17 days earlier on June 30. Of course, the fifth prong of Section 547(b) would not be satisfied if, at that time, New Hope was fully secured, but that is a matter of fact inappropriate to resolve on a motion to dismiss. Likewise, fact based defenses under Section 547(c) might also be available to New Hope – new value or contemporaneous exchange,[12] for example – that are likewise

[11] Performance Plus Agency Agreement, ¶ 1(c), Bates CCCI 1191.

[12] For example, at the time the June 30 agreement was signed, ML was holding a cashier's check from CCCI for $30,000. The amount that was paid 17 days later was only $2,500.

inappropriate to resolve on a motion to dismiss.

For the foregoing reasons, the motion to dismiss will be granted as to ML with leave to amend within 10 days to state a claim against New Hope should plaintiff choose to do so. Failure to file an amended complaint as to this count will result in the final dismissal of the preference claim.

I. Ninth Claim for Relief – Agreement under Coercion and Duress against ML[13]

This claim seeks to void the extension agreements because of coercion and duress and for the return of the $32,250 extension fee that was actually paid. As a condition of extending the date of the trustee's sale, ML required CCCI, through Pastor Lee, to sign an agreement acknowledging the debt, including many of the fees and charges now challenged in this proceeding.

The Arizona Court of Appeals carefully reviewed the doctrine of duress in *Inter-Tel, Inc. v. Bank of America*, 195 Ariz. 111, 985 P.2d 596 (App. 1999). After confirming that Arizona follows the Restatement in determining duress, the Court stated:

> In *Frank Culver Elec., Inc. v. Jorgenson*, 136 Ariz. 76, 77-78, 664 P.2d 226, 227-28 (App.1983), we said that duress exists if one party is induced to assent to a contract by a wrongful threat or act of the other party.
>
> Normally, duress does not exist merely because one party takes advantage of the financial difficulty of the other. *See USLife Title Co. v. Gutkin*, 152 Ariz. 349, 356-57, 732 P.2d 579, 586-87 (App.1986); *Frank Culver Elec., Inc.*, 136 Ariz. at 78, 664 P.2d at 228. It is a different matter, however, when the wrongful act of one party is the very thing that created the other party's financial difficulty. This refinement to the general rule can be inferred from two Arizona decisions. *See Fridenmaker v. Valley Nat'l Bank*, 23 Ariz. App. 565, 572, 534 P.2d 1064, 1071 (1975) (no duress because agreement was not executed to escape duress caused by improper actions of defendant); *Republic Nat'l Life Ins. Co. v. Rudine*, 137 Ariz. 62, 66, 668 P.2d 905, 909 (App.1983) (no economic duress to avoid stipulation, especially since defendants were not responsible for plaintiff's lack of bargaining power).

195 Ariz. at 117, 985 P.2d at 602.

In this case, CCCI and ML entered into the extension agreements in order to postpone the

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[13]The count is styled as against both ML and New Hope but allegations are made involving New Hope and no relief is sought against New Hope.

trustee's sale for a short period. The conditions were acknowledgment of the debt and payment of the fee. CCCI alleges that the payment and acknowledgment were "made necessary by ML's wrongful acts, including but not limited to, the undisclosed, excessive, deceptive and illegal fees, charges, and interest accruing on the Note, their promises to refinance and/or extend the maturity of the Note . . ., and subsequent inexplicable refusal to do so." In framing the issue this way, CCCI argues that the requirements of Arizona law would be met if these allegations were proven; i.e., that the listed acts were "the very thing that created the other party's financial difficulty" and that "circumstances permitted no alternative." *Id.*

But the undisputed facts are to the contrary. CCCI readily admits that it did not pay the debt by the date of maturity. Its need for an extension resulted from non-payment and the inability to refinance, both of which are acknowledged. And, there was, of course, an alternative that did not require payment of the fee or acknowledgment of the debt and that is the alternative CCCI eventually took – it filed Chapter 11. This is quite unlike *Inter-Tel*. In that case, the company's credit line was expiring and, it was alleged, the company's inability to get new credit from a different source had been severely undermined by its lender having moved the debt into the special assets department. Inter-Tel needed more than an automatic stay; it needed new money, and it could not get any allegedly because of the bank's prior actions. Therefore, summary judgment was reversed that had upheld the validity of a release the bank had required as part of a restructuring.

Here, CCCI asked for, and received, the extensions. While CCCI argues that its inability to refinance, and thus its need for the extensions, resulted from the "excessive" charges arising out of the PPP, it is uncontroverted that the precipitating fact was the failure to pay the debt when it matured. Even if CCCI could eventually prove the allegations set forth above, no claim for coercion would lie, given this unalterable fact and the requirements of Arizona law.

Therefore, the ninth claim for relief will be dismissed.[14]

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[14]The First Amended Complaint also contains a Tenth Claim for Relief that, like the Fourth Claim for Relief, is premised upon violations of A.R.S. § 6-947. CCCI has now filed a Second

J. The Jury Trial Issue

The jury trial issue is not yet ripe and no adequate record has been made on the effectiveness of the purported waiver. Therefore, the Court will issue no ruling on this question.

IV. Conclusion

This will recap the decisions of the Court:

1. Motion to dismiss First Claim for Relief will be denied.
2. Motion to dismiss Second Claim for Relief will be granted.
3. Motion to dismiss Third Claim for Relief will be granted.
4. Motion to dismiss Fourth Claim for Relief will be denied.
5. The Fifth Claim for Relief will be dismissed as moot.
6. Motion to dismiss Sixth Claim for Relief will be denied.
7. Motion to dismiss Seventh Claim for Relief will be granted.
8. Motion to dismiss Eighth Claim for Relief will be granted, with leave to amend.
9. Motion to dismiss Ninth Claim for Relief will be granted.

These rulings will remove Mortgages Ltd. Securities, L.L.C. from this case as it was only named in the Seventh Claim for Relief, which will be dismissed. The only remaining claim against New Hope is the Fourth Claim for Relief, which is fundamentally a claim objection, unless Plaintiff amends to state a preference claim against New Hope.

Counsel for ML is to submit a form of order.

DATED: August 15, 2007

CHARLES G. CASE II
UNITED STATES BANKRUPTCY JUDGE

Amended Complaint (adding a claim for breach of fiduciary duty), which deletes the Tenth Claim for Relief. Therefore, the Court concludes that this claim has been abandoned.

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