IN THE SUPREME COURT OF MISSOURI

Case No. SC91951

FIRST BANK,

Plaintiff/Respondent,

v.

FISCHER & FRICHTEL, INC.,

Defendant/Appellant.

Appeal from the Circuit Court of St. Louis County
Case No. 08SL-CC04789
Honorable John F. Kintz

APPELLANT'S SUBSTITUTE REPLY BRIEF

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ARGUMENT

I. THE DEED OF TRUST LANGUAGE IS NOT CONTROLLING AND THE RESTATEMENT STANDARD EQUALIZES THE RISK OF MARKET FLUCTUATIONS BETWEEN THE LENDER AND THE BORROWER.

A. First Bank has not explained and cannot explain how the current method of measuring a deficiency provides any protection to borrowers.

First Bank and amicus curiae,[1] for all their various arguments in favor of the current deficiency standard, do not explain how the standard protects borrowers against unfair or opportunistic behavior by a lender in deciding how much to pay at a foreclosure sale. They want the Court to believe that they are valiantly laboring under the current deficiency process and that the Restatement framework would burden them further. In their view, the only goal of the Court in measuring a deficiency after foreclosure should be to protect lenders. What they would like the Court to ignore is that the current system does not provide any protection for the borrower, and it certainly did not protect Fischer & Frichtel in this case.

Here, First Bank chose to pay whatever amount it desired at the foreclosure sale, which turned out to be $466,000.00. To arrive at this number, First Bank estimated that

[1] The Business Bank of St. Louis ("Business Bank") filed an amicus brief that relies on "facts" that were not even offered at trial, or are unsupported argument. The brief should be disregarded.

the property was worth $675,000.00.[2] Tr. at 161:4-10. First Bank did not introduce any evidence at trial supporting this alleged value. The $675,000.00 amount already included a discount "[b]ased on the carrying costs to keep the property up as the new owner of, the HOA fees, [and] . . . the property taxes[.]" Tr. at 161:8-13. First Bank then decided to "further discount[] it from 675 to $466,000[.]" Tr. at 161:13-14. The bank's corporate representative testified that this amounted to unfairly discounting twice for the same thing: the "carry" of the property over a period of time before all lots could be sold. Tr. at 273:6-10 ("Q. Okay. So my question is, in determining the price that it decided to pay at the foreclosure sale, isn't it true that First Bank double-counted the discount for the carry? A. Yes. Q. Your answer is yes? A. Yes. Q. Do you think that's fair? A. No."). First Bank admitted that it – the only bidder at foreclosure – purchased the property for less than its fair market value. Tr. at 186:3-6.

First Bank now seeks a deficiency judgment based on its bid amount – a number that it created without justification. The banks argue that they are the victims in this situation, but only one party has admitted to acting unfairly in determining that price and, therefore, the amount of the deficiency. At the heart of the banks' argument is that the law should leave the borrowers at the mercy of the banks' good intentions and self

[2] First Bank made this estimate despite its own internal records indicating that the property was worth $1,134,000.00 on September 5, 2008, only three months before the foreclosure sale. Tr. at 179:24-180:14; Exhibit G.

interest when determining the deficiency amount. That provides no protection to borrowers and should not be the law in Missouri.

The statutory redemption procedure, championed by First Bank as the borrower's protection, does not protect borrowers and did not protect Fischer & Frichtel in this instance. *See Respondent's Brief* at p. 30-31. The statutes provide no protection to a borrower that cannot afford to redeem its entire loan. Fischer & Frichtel's loan provided for repayments of principal to coincide with sales of home lots. Tr. at 213:11-19. The statutory redemption therefore does nothing to protect a borrower against an excessive deficiency. The lender forecloses, the borrower cannot afford the entire loan amount, plus interest and costs, and the lender can then proceed with a low bid and seek an unfair deficiency. Borrowers are not protected.

The Eastern District recognized the importance of this issue and need for the existing law to be reexamined. "Many commenters have observed that the foreclosure process commonly fails to produce the fair market value for foreclosed real estate." *First Bank v. Fischer & Frichtel*, 2011 WL 3558118, at *4 (Mo. App. E.D. Aug. 9, 2011) (quoting Restatement (Third) of Property: Mortgage § 8.3 *comment a*). States have adopted the fair market value approach, but Missouri "continue[s] to adhere to the common-law rule[.]" *Id.* (quoting Restatement (Third) of Property: Mortgages § 8.4 Reporter's Note). That rule was set forth in Missouri over seventy years ago, "and the issue is of continuing importance." The status quo is under examination because of the

"general interest or importance of [the] question involved in the case or for the purpose of reexamining existing law." *Id.*

B. The Deed of Trust language provides no guidance to determine the measure of a deficiency.

The argument by First Bank and amicus that the trial court was bound to award a deficiency to the bank measured by the outstanding principal less the foreclosure sale price is a red herring. First Bank argues that the deed of trust "set[] any deficiency to which First Bank was entitled" because the Deed of Trust stated that the borrower would "pay upon demand any deficiency remaining." *Respondent's Brief* at p. 18-19. Citing no authority, First Bank states that this phrase "necessarily refer[s] to the difference between the amount due on the Note and the foreclosure bid price." *Id.* at 19.

At the outset, this is the first time that this argument has been advanced in this litigation. The Deed of Trust was not mentioned in First Bank's unsuccessful Motion for Summary Judgment. L.F. 166-213. The Deed of Trust was entered as a trial exhibit, but there was no testimony about the language upon which First Bank now relies and no argument to the trial court regarding its significance. Tr. at 144:17-150:8 (First Bank vice president reads portions into evidence, but not the portion referencing a "deficiency"). A point raised for the first time on appeal is not preserved for review. *Jones v. Jones*, 658 S.W.2d 483, 488 (Mo. App. E.D. 1983). Therefore, First Bank's argument should be disregarded as untimely.

First Bank cites authority only for the proposition that "[t]he terms of the Note and Deed of Trust control the amount of deficiency that First Bank is entitled to recover." *Respondent's Brief* at p. 19 (citing *Robbins v. McDonnell Douglas Corp.*, 27 S.W.3d 491, 496 (Mo. App. E.D. 2006) *and Lake Cable, Inc. v. Trittler*, 914 S.W.2d 431, 436 (Mo. App. E.D. 1996)). Neither *Robbins* or *Lake Cable* supports First Bank's argument. In *Robbins*, the Court interpreted an employment contract that in no way related to a deficiency action. 27 S.W.3d at 496. The Court in *Lake Cable* affirmed the calculation of a stock's value based on its "book value," as opposed to its "fair market value," because the parties' agreement expressly provided for valuation by that method. *Id.* at 433. In contrast, the Deed of Trust here does not define "deficiency."

The definition of "deficiency" begs the question at the center of this Point on Appeal: how is the deficiency defined in Missouri? Will it be determined by whatever amount the lender decides to bid, or will it be determined by the property's fair market value? The Deed of Trust provides no insight into the definition of "deficiency." The definition of "deficiency" will be determined by the law in Missouri.

Further, Courts have not relied upon the language of the deed of trust to measure the deficiency. None of the cases upon which First Bank relies to measure the deficiency cite to language in a deed of trust in an attempt to define "deficiency." *See Drannek Realty Co. v. Nathan Frank, Inc.*, 139 S.W.2d 926 (Mo. 1940); *Hewitt v. Price*, 102 S.W. 647 (Mo. 1907); *Reed v. Inness*, 102 S.W.2d 711 (Mo. App. 1937). The measure of the deficiency is controlled by the Court and, absent clear intent on the part of the parties to

do something different, the parties meant to follow the law. There is no such clear intent in the Deed of Trust language that the borrower will "pay upon demand any deficiency remaining." The fact that this argument has never been raised, and the scant attention that First Bank gives it in its Respondent's Brief, demonstrate the little credit that the argument deserves.

C. First Bank admitted that it was seeking a windfall in this foreclosure and deficiency action.

First Bank and amicus argue that Fischer & Frichtel rely on a "false premise that lenders use foreclosure sales and deficiency claims to obtain windfall profits on secure loans." *Respondent's Brief* at p. 27. Fischer & Frichtel's statement is not false. It is a fact admitted by First Bank. First Bank argued that its bid at foreclosure was based on an initial valuation of $675,000.00 for the property (although the bid was for only $466,000.00). Tr. at 161:4-10. First Bank's vice president testified that, even if First Bank earned that amount from the resale of the lots (over $200,000.00 less than the only appraisal entered into evidence), and collected the deficiency judgment it sought from Fischer & Frichtel, it would reap $1.4 million, plus attorneys' fees, costs and interest, on a $1.1 million debt. Tr. at 273:22-274:11. First Bank therefore sought a windfall of at least $300,000.00 from its foreclosure and deficiency action. If the property resold for its fair market value of $918,000.00, the windfall would be over half a million dollars.

While First Bank and amicus speak broadly of banking practices and what they say "commonly" occurs, the facts entered in this case show that First Bank *is* seeking a

windfall. First Bank pontificates at length that a foreclosing bank "does not expect to sell the collateral for a windfall," citing to nothing. *Respondent's Brief* at p. 28. This assertion is not supported by a citation in the record and is merely self serving rhetoric. In the current climate, it is bold indeed to suggest that banks do not seek their own interests and profits whenever possible. What has happened in this case is that First Bank saw an opportunity to earn several hundred thousand dollars in foreclosure and a deficiency action, and acted on that opportunity. That is precisely the opportunistic behavior that the Restatement is designed to prevent, and that is why First Bank and the Missouri Bankers Association are so vehemently opposed to it.

Amicus Business Bank argues that banks do not profit from the foreclosure process. *See Business Bank Brief* at p. 57. This is not true. In fact, Fischer & Frichtel is aware of a recent situation in which Business Bank itself was the only bidder at the foreclosure sale of its borrower's commercial property, purchased the property for $2,000,000.00, and sold it four months later for $2,650,000.00. *Appendix to Reply Brief* (material portions of deposition transcript of Business Bank in *The Business Bank of St. Louis vs. MPD Investments, LLC*, no. 10SC-CC02512 in the Circuit Court of the County of St. Louis) at 108:10-17; 109:13-18; 133:19-134:3. Business Bank did not credit any portion of the $650,000.00 difference to the borrower or guarantors in its deficiency action. *Id.* at 134:4-8.

First Bank and amicus go farther, arguing that banks do not seek foreclosures and, in fact, try to avoid them. *See Respondent's Brief* at p. 27-30. Despite the banks'

characterization, a foreclosure is not an unstoppable force bearing down on lenders. Instead, the *lender* makes the decision whether to foreclose. First Bank made that decision here. First Bank obviously decided that it was more profitable to foreclose than to extend the note terms and continue collecting interest payments (it had already collected $632,000.00 in interest on the loan). *See* Tr. at 219:21-220:2. First Bank made the most profitable decision for First Bank, which was to foreclose quickly, bid low, and seek an inflated deficiency. The argument that banks "have no desire or incentive to own property" is refuted by the evidence in this case that First Bank ended a profitable relationship with a borrower and chose instead to foreclose on, and own, its secured property.

D. The fair market value appraisal provided by Fischer & Frichtel and adopted by the jury accounted for an extended marketing period.

The appraisal provided at trial by Fischer & Frichtel's expert appraiser accounted for the "practical realities" that First Bank argues support measuring a deficiency by the foreclosure sale price. *See Respondent's Brief* at p. 33-34. First Bank argues that the appraisal obtained by Fischer & Frichtel was somehow erroneous because the bank has not yet sold the foreclosed property.[3] *Respondent's Brief* at p. 34. That is precisely the situation anticipated in the appraisal entered into evidence by Fischer & Frichtel valuing

[3] This allegation necessarily involves facts outside of the record (evidence of the bank's failure to sell the property until the time the brief was filed) and should be stricken. *State v. Strong*, 142 S.W.3d 702, 728-29 (Mo. 2004).

the property at only $918,000.00. *See* Defendant's Exhibit B at p. 2. First Bank admitted in testimony that the term 'discounted wholesale value' "takes into consideration the cost of keeping the land for a period of time, including taxes, marketing, insurance, and the time value of money[.]" Tr. at 177:23-178:2. The marketing period accounted for in the $918,000.00 discounted wholesale value appraisal was four and a half years from the foreclosure date. Tr. at 305:19-307:9. The foreclosure sale was held on December 11, 2008, or less than three years ago. *See* Tr. at 152:12-153:5. The marketing period therefore has not terminated, and First Bank presented no relevant evidence of the inaccuracy of the appraisal or its method. Its criticism is premature at best. Further, First Bank had the opportunity to present its own evidence of the property's fair market value at foreclosure, or to question the appraiser about the holding period. It did not do so. Why? We can only conclude that it knew that the methods used by the appraiser, one it and other banks had used in the past, and the conclusions reached were reasonable and consistent with practice in the industry. *See* Tr. at 293:19-294:4; 298:7-18; 324:8-10. The jury accepted Fischer & Frichtel's appraiser's opinion and determined the deficiency accordingly.

Further, although First Bank (without support from the record) alleges that it has not sold the property, implying that the appraisal was incorrect, there was substantial evidence at trial that First Bank has not attempted to sell the property. The appraiser who testified in this case stated that, as of the date of trial, the property was not listed in MLS, there were no signs advertising sale on the site, and he saw no evidence that First Bank

was attempting to sell the property. Tr. at 318:23-319:2; 327:11-22. First Bank wants it both ways: it pleads that it has been unable to sell the property, but there is no evidence that it has attempted to do so.

First Bank also argues that Fischer & Frichtel does not explain what the "contemporary understanding of deficiency actions following foreclosure" is or why it supports adoption of the Restatement. *Respondent's Brief* at p. 33. Contrary to what First Bank states, the "contemporary understanding" is not referring to the recent economic downturn. Instead, the cases cited by First Bank to support its deficiency measurement clearly do not take into account modern banking practices.[4]

The length of notice provided the public for the foreclosure sale was twenty two days. Tr. at 185:5-9. First Bank admitted that it was nearly impossible for any potential bidder to acquire a loan in that time to make a bid on the foreclosed property. A borrower would have to be vetted first, including submission of financial statements and completion of title work, an appraisal and/or an environmental analysis. Tr. at 332:25-333:16. First Bank's vice president, a loan officer with twenty years of experience, testified that "the shortest amount of time and the number of days that the whole process has ever taken" in his experience was forty five days. Tr. at 134:12-135:14; 333:17-24. He could "conceive" the shortest amount of time the process could take as

[4] In its opinion transferring to this Court, the Eastern District noted that the traditional view "was set forth in *Drannek* more than seventy years ago and the issue is of continuing importance." 2011 WL 3558118, at *4.

"[a]pproximately 30, 45 days." Tr. at 334:8-10. The "contemporary understanding" is that the lender is the only party that can reasonably bid at a foreclosure sale such as this because the lender can make a credit bid, as opposed to any other bidder, who must bid in cash. Tr. at 150:12-16; 154:14-21; 156:13-22. First Bank's officer's testimony shows that, today, the lender completely controls the sale *and purchase* of foreclosed property because the terms of the sale foreclose other bidders from obtaining financing to make a bid.

E. The Courts, and not the Legislature, control the law of deficiency actions.

Deficiency actions have always been controlled by the Courts. First Bank argues that the Restatement can be adopted only by the Legislature. *Respondent's Brief* at p. 36. First Bank makes no attempt to address or distinguish *Kennedy v. Dixon*, 439 S.W.2d 173 (Mo. banc 1969), in which the Court adopted a Restatement provision to govern choice of laws. *Appellant's Brief* at p. 32-33. The provision adopted changed the law in Missouri. It is well within this Court's power to make adjustments to aging law that does not comport with the contemporary state of the law in most jurisdictions or fundamental fairness. The Restatement also acknowledges the jurisdictions that have adopted a fair market value standard judicially, and states that "[t]he principles of this section are applicable whether a statute requires it or not." Restatement (Third) of Property: Mortgages § 8.4 *comment b*.

First Bank argues that there will be many issues that arise with the adoption of the Restatement. The Court in *Kennedy* considered that its decision would raise the same

kinds of questions, and found that "[t]his new rule for the choice of law will make the judicial task more difficult, at least until additional cases have established further guidance." 439 S.W.2d at 185. There would no longer "be a mere mechanical determination" of the choice of laws, but the Courts would work through establishing a procedure for difficult cases. *Id.* The same will occur with judicial adoption of the Restatement. The Restatement itself will provide a framework for measuring a deficiency following foreclosure, and the Courts will address the unique circumstances of each deficiency suit, just as they do now, and just as would be done by the adoption of a new statute governing the suits. Courts in Florida, Mississippi, Montana, Vermont and Tennessee have adopted the fair market value approach, and there is no reason to expect that adopting the approach in Missouri would lead to a collapse in the lending or foreclosure processes. *See* Restatement (Third) of Property (Mortgages) § 8.4 *comment a* (2010); *Lost Mountain Dev. Co. v. King*, 2006 WL 3740791, at *7 (Tenn. Ct. App. Dec. 19, 2006). If the lending or foreclosure processes in those states had collapsed upon judicial adoption of the fair market value standard, First Bank and amicus would have certainly brought it to the Court's attention.

Further, many of the "multitude of issues" that First Bank argues "must be considered and answered" before "a change of this scope is adopted" are addressed by the Restatement itself. *See Respondent's Brief* at p. 36-37. First Bank tries to create uncertainty about the Restatement standard by speculating about the effect of a third party bidding at the foreclosure sale. *Respondent's Brief* at p. 35-37. The Restatement

addresses this: "This section applies irrespective of whether the foreclosure purchaser is the mortgagee or a third party." Restatement (Third) of Property: Mortgages § 8.4 *comment b*. First Bank also wonders what. The Restatement also addresses the effect of senior liens the foreclosure: "Where the foreclosure is subject to senior liens, the amount of those liens must be subtracted from the fair market value in calculating the deficiency." *Respondent's Brief* at p. 37; Restatement (Third) of Property: Mortgages § 8.4 *comment b*. The Restatement defines "fair market value." *Id.* at *comment c*; *Respondent's Brief* at p. 36. The Restatement protects guarantors. Restatement (Third) of Property: Mortgages § 8.4 *comment b*; *Respondent's Brief* at p. 37. Any waiver of the Restatement protections, executed contemporaneously with the mortgage documents by a person against whom a deficiency is sought, is ineffective. Restatement (Third) of Property: Mortgages § 8.4 *comment b*; *Respondent's Brief* at p. 37. The drafters of the Restatement did not mindlessly construct its provisions. While it is not possible for even the Legislature to anticipate every situation, the Restatement accounts for many possibilities, and our Courts are equipped to handle the unique characteristics of the individual deficiency actions.

F. Adoption of the Restatement does not shift all risk of a mortgage loan to the lender.

Much of First Bank's argument opposing the Restatement focuses on the concept that its adoption will lead to lenders bearing the full burden of a decline in the real estate market without sharing in the profits of growth. The opposite is true. The fair market

value approach takes into account the rise and fall of the market. As explained above, by measuring the deficiency by the amount bid at foreclosure, the lender establishes the deficiency at whatever amount it chooses, in whatever economy it chooses. Measuring the deficiency by the fair market value allows the risk to fall equally between the parties. Under the Resatement's approach, the fair market value of the property is determined as of the date of the foreclosure. Any appraisal will thus account for the current state of the economy and property values. If the market has gone down since the loan was made, as was the case here, the appraisal will reflect a lower market value, protecting the bank. This is exactly what happened here. Mr. Westover, the appraiser who testified at trial, testified that he conducted an appraisal (for another bank) of the same property only months before the foreclosure sale. Tr. at 308:13-16. The appraised value of the property at that time was $999,000.00. *Id.* He later valued the property as of the foreclosure date at $918,000.00. Tr. at 304:13-19; 307:10-14. The value dropped because of the "recession going on" and the resulting increase in the discount rate, which is the period that the property will be marketed in order to sell. Tr. at 308:17-309:10; 305:19-306:9. Further, the property had earlier appraised for over $1.1 million. Tr. at 169:2-5;173:15-19; 180:8-14; 183:18-184:1; 273:22-274:1; Exhibits D, F and G. Mr. Westover "absolutely" took into account the "current economic circumstances in coming to [his] opinion regarding the value of [the] property." Tr. at 326:7-11. The marketing period (also called the absorption rate) is a part of the consideration of the economic circumstances that were taken into account. Tr. at 327:1-4.

The appraisal, using a discounted wholesale method, therefore took into consideration the market fluctuations about which First Bank is concerned. Under the Restatement standard, because the fair market value of the property had dropped, First Bank could seek a larger deficiency judgment. Had the appraisal not taken the market fluctuation into account, the fair market value would have remained at $1.1 million, and the jury's deficiency finding would have been zero.

First Bank's concerns about the accuracy of the appraisals or veracity of the appraisers, particularly Mr. Westover here, have no merit. Mr. Westover testified that he typically conducts appraisals for banks. Tr. at 293:19-294:4. Ninety percent of the appraisal work he does is for banks. Tr. at 324:8-10. In fact, from 2000 through 2008, Mr. Westover conducted approximately 400 appraisals *for First Bank*. Tr. at 298:7-18. The banks themselves consistently rely upon an appraiser's value when making lending determinations. *See* Tr. at 293:25-294:4. Only now, when those appraisals may be used to fairly measure the deficiency sought from their borrowers, do the banks complain about the "uncertainty inherent in an appraiser's estimate of market value." *See Respondent's Brief* at p. 31. A property's fair market value is routinely considered and relied upon by Courts. *See, e.g.*, *Glaize Creek Sewer Dist. of Jefferson County v. Gorham*, 335 S.W.3d 590, 594 (Mo. App. E.D. 2011) (measuring damage in condemnation action); *In re Estate of Creech*, 120 S.W.3d 271, 275 (Mo. App. E.D. 2003) (determining damages for discovery of assets in probate). Missouri Courts have

shown that they trust the determination of a fact-finder to establish the fair market value of property upon competent evidence.

First Bank does not want the deficiency measurement to be determined by appraisers. *See Respondent's Brief* at p. 32. First Bank wants to maintain the status quo because, until now, lenders have completely controlled the process. They set the foreclosure sale date, determine the amount of time that notice will be published and how much to publicize the sale (within statutory requirements), and determine how much to bid. In fact, none of this changes under the Restatement. What does change is that, if the lender has taken advantage of the system and bid less than the fair market value, which occurred here, and then pursues a deficiency, there is protection for the borrower. If the lender feels that the borrower's appraisal of fair market value is inflated, it is welcome to introduce its own evidence of fair market value.

First Bank had that opportunity here. Although it now seeks, in the event of a reversal, a second chance to introduce its own fair market value, First Bank did in fact have that chance. *See Respondent's Brief* at p. 40-41. First Bank certainly knew that the issue would be tried – its Motion for Summary Judgment, Motion to Strike Affirmative Defenses and alternative jury instructions had all been denied. L.F. 714; 741; 929; 935. Further, on the eve of trial, First Bank named an appraisal expert and noticed his deposition. Supplemental Legal File ("S.P.L.F.") 1-2; 18-22. Fischer & Frichtel filed motions to quash the deposition and exclude the expert testimony. S.P.L.F. 3-17. The motions were denied, clearing the way for First Bank to enter the evidence. L.F. 741-

742. First Bank chose not to introduce the evidence, but it now wants a second chance to do so.

First Bank also attempts to draw a distinction between evaluating fair market value in a condemnation action and in the foreclosure context, arguing that the issue in a foreclosure is "how best to make the lender whole[.]" *See Respondent's Brief* at p. 32. Of course the bank argues that the process that allows it to set the price paid and potentially obtain a windfall is the best process. Rather, the goal should be a process that best balances the interests of the lender and the borrower. That is the Restatement process. In this case, if the deficiency is measured by any amount less than the fair market value, First Bank will be made better than whole – it will receive a windfall, potentially of several hundred thousand dollars. Tr. at 273:22-274:11.

First Bank argues that it "should not have to bear entirely the risk that a judge or jury will adopt the opinion offered by the borrower's appraisal[.]" *Respondent's Brief* at p. 33. First, as explained above, First Bank could have introduced its own appraisal evidence at trial, but chose not to do so. If the lender chooses not to introduce any evidence of the property's fair market value, it can hardly cry foul when the judge or jury finds in accordance with the only evidence presented. Further, who "entirely" bears the risk now? It is the borrower that carries the risk that, as in this case, the lender will bid approximately one half the fair market value of the property, and then pursue it for the "deficiency" that the lender's low bid created. First Bank cries of the risk it must burden

under the Restatement, but the only risk it faces is that it will be placed at equal footing with the borrower.

Finally, First Bank characterizes the lending relationship as one that benefitted Fischer & Frichtel exclusively. *See Respondent's Brief* at p. 26-27. First Bank argues that it "does not expect to receive more than repayment of the underlying indebtedness if the borrower's transaction is successful and profitable." *Id.* at 26. It also alleges that, when lots were selling, "First Bank did not expect to share in those profits." *Id.* First Bank did not loan money to Fischer & Frichtel out of the kindness of its heart. During the loan's life, Fischer & Frichtel paid $632,000.00 to First Bank in interest, on top of the $1.4 million in principal. Tr. at 219:15-23. Fischer & Frichtel paid all interest on the loan during the years that it sold no lots. Tr. at 219:5-10; 219:24-220:2; 222:25-223:3. First Bank is in the business of lending money, and it earned over $600,000.00 in interest payments from Fischer & Frichtel, whether or not Fischer & Frichtel's development was "successful and profitable" during that period.

G. There will be no material changes in the foreclosure process or lending system.

Adoption of the Restatement would lead to changes in deficiency actions, not in the foreclosure statutes or process. The foreclosure statutes would stay exactly as they are. First Bank cannot point to a single conflict between any provision of the Restatement and any existing foreclosure statute. Instead, it argues that the foreclosure process "is intended to provide a fair and reasonable procedure for selling collateral while

leaving a share of the ultimate risk on the borrower[.]" *Respondent's Brief* at p. 34. That is not what the testimony showed.

First Bank's vice president testified that the process by which it bid at the foreclosure was *not* fair. Tr. at 273:6-10 ("Q. Okay. So my question is, in determining the price that it decided to pay at the foreclosure sale, isn't it true that First Bank double-counted the discount for the carry? A. Yes. Q. Your answer is yes? A. Yes. Q. Do you think that's fair? A. No."). Under the foreclosure framework that First Bank advocates, this type of patently unfair behavior is acceptable and there is no existing process to check a bank's actions. The lender is granted every advantage in concocting its own bid to determine the size of the deficiency.

First Bank argues that adoption of the Restatement will require lenders to address the issue of fair market value prior to the foreclosure sale. *Respondent's Brief* at p. 35. First Bank paints this as a unique burden when, in fact, it is already First Bank's practice. In the months leading to foreclosure, First Bank repeatedly appraised the property internally. On April 15, 2008, First Bank valued the property at $1,133,000.00. Tr. at 166:19-167:22; 169:2-5. On June 3, 2008, it valued the property at $1,134,000.00. Exhibit D; Tr. at 173:15-19. On September 4 and 5, 2008, it twice valued the property at $1,134,000.00. Exhibit F; Tr. at 183:18-184:1; Exhibit G; Tr. at 180:8-14. Prior to foreclosure, First Bank also received a copy of an appraisal from Mr. Westover appraising the property at $999,000.00. Tr. at 174:25-175:12; 176:12-17. The evidence

showed that First Bank already made a practice of regularly appraising the property that secured its loans. There is no additional burden under the Restatement.

First Bank also champions the foreclosure process as a "competitive bidding process." The evidence in this case showed that there was no competition. First Bank was the only bidder, just as it had arranged and that the lending system had ensured. As explained above, the foreclosure notice period was twenty two days, bidders were required to pay cash, and cash could not be obtained from a lender in less than thirty to forty five days. First Bank was the only bidder at the foreclosure sale. Tr. 153:23-154:13. There was no competitive bidding process; there was only First Bank choosing the amount to bid and, consequently, the amount at which it wanted to set the deficiency. Neither First Bank or amicus have provided any evidence to counter these facts. They ask the Court to assume that foreclosure creates a "competitive bid process." Rather, the evidence is to the contrary.

Missouri has produced limited caselaw in the measurement of deficiencies. Most states have adopted some form of fair market value approach to measuring deficiencies. *See* Restatement (Third) of Property: Mortgages § 8.4 Reporter's Note *comments a and b* (thirty states have adopted a form of fair market value deficiency measure); *Lost Mountain Dev. Co.*, 2006 WL 3740791. The abuse of borrowers and the deficiency suit process that is possible in a modern banking system is evident here. The Restatement sets out to remedy this unfairness. Without its protections, a borrower in a modern deficiency suit is subject to the impulses of the lender at the foreclosure sale: how much

does the lender feel like crediting today? Here, despite First Bank knowing the property was valued at or near the amount of the outstanding loan, it arbitrarily priced the property down more than 50%. Without the Restatement's protections, a bank can bid any amount it wants, and then pursue the borrower for the deficiency created.

The Restatement provides a simple protection: if a bank wants to pursue a deficiency, that deficiency is set by the fair market value, and not by the bank's own whims. The Court should adopt its protection.

H. The Restatement should apply equally to this case and to prospective cases.

First Bank asks the Court to apply the Restatement only to loans and deficiency actions that arise in the future. First Bank cites nothing to support its proposition that a Court should not act immediately to protect one party from being taken advantage of by another. This would not be the first instance in which a Missouri Court has adopted law that would "alter the costs and benefits associated with a bargained-for contract." *See Respondent's Brief* at p. 40. In *Boyle v. Vista Eyewear*, 700 S.W.2d 859 (Mo. App. W.D. 1985), *adopted in Fleshner v. Pepose Vision Institute, P.C.*, 304 S.W.3d 81 (Mo. 2010), an employee sued her former employer following her discharge. The Court adopted public policy exceptions to the employment at will doctrine, including the exception that an employee may not be fired at will for refusing to perform an illegal act. *Id.* at 876-77. The exceptions were adopted for the first time in Missouri from the caselaw of a variety of other states. *Id.* at 872-76. Even though the exceptions were adopted for the first time,

the Court allowed the plaintiff to amend her petition upon remand to reflect the exceptions. *Id.* at 878.

Delaying application of the Restatement would leave Fischer & Frichtel, as well as countless others, to face unfair practices without protection. All sophisticated businesses, including First Bank, face the prospect that the law may change. They cannot simply assume that each advantage they hold will be held forever. The law under which their actions are interpreted may change with the adoption of more contemporary jurisprudence.

II. FIRST BANK FAILED TO PRESENT EVIDENCE TO SUPPORT INTEREST CALCULATION.

In its Respondent's Brief, First Bank fails to respond in any way to the most fundamental argument underlying Fischer & Frichtel's Point II – that the interest award had no basis in evidence or logic.

First Bank's representative testified regarding the total amount of interest sought based on the total principal amount sought. Tr. at 156:23-157:13 (seeking $667,875.75 principal and $75,642.46 interest). He gave no testimony that could guide the jury on how to calculate interest. The jury was justifiably confused and sought clarification from the trial court, which could provide none. L.F. 771; Tr. at 360:23-361:25. The jury then awarded only one-third of the principal sought, but one-half of the interest. L.F. 937. There is no support for this award.

First Bank cannot deny that the interest award was not proportional to the principal award. It gave the jury no way to properly calculate the award. The judgment should be reversed for lack of supporting evidence.

III. THE DOCTRINE OF GOOD FAITH AND FAIR DEALING EXISTS IN ALL CONTRACTS AND THE DEFENSE INSTRUCTIONS FOLLOWED THE LAW AND WERE READILY UNDERSTOOD.

A. The law imposes a covenant of good faith and fair dealing in all contracts, and First Bank fails to address the facts of its own actions that violated the covenant.

Every contract includes an implied duty of good faith and fair dealing. *City of St. Joseph v. Lake Contrary Sewer Dist.*, 251 S.W.3d 362, 369 (Mo. App. W.D. 2008). First Bank violated that duty by failing to pay fair market value through its manipulation of the foreclosure and deficiency processes, to its advantage, and failing to renew the Note on commercially reasonable terms. The two cases First Bank cites in support of the proposition that it "did not have a duty to pay 'fair market value' for the property at the foreclosure sale" have nothing to do with fair market value or foreclosure sales. *Respondent's Brief* at p. 47. Neither *Cordry v. Vanderbilt Mortg. & Fin., Inc.*, 370 F. Supp. 2d 923 (W.D.Mo. 2005), or *Centerre Bank of Kan. City, N.A. v. Distrib., Inc.*, 705 S.W.2d 42 (Mo. App. W.D. 1985), addresses paying fair market value for property at a foreclosure sale. In fact, neither case involves a foreclosure sale at all.

First Bank's attempts to distinguish authority supporting the instruction are likewise unavailing. First Bank attempts to limit the holding in *Regional Investment Co. v. Willis*, 572 S.W.2d 191 (Mo. App. 1978), to the lender's actions in obtaining a contract for sale of a property prior to the foreclosure sale. *Respondent's Brief* at p. 51. The

Willis Court ordered the trial court to take into consideration the amount of the bid, compared to the value committed at a willing sale to a willing buyer (a.k.a, the fair market value), to determine the amount of the deficiency. *See id.* "The facts . . . show[ed] that there [was] a doubt as to the fairness of the trustee's sale because of the conduct of [the lender]." *Id.* Fischer & Frichtel sought relief from the trial court under the same theory: that First Bank's conduct and bid amount cast doubt on the fairness of the sale and deficiency action.

First Bank makes no attempt to explain the facts presented that it breached the duty by bidding below fair market value. *See Appellant's Brief* at p. 56-57. Despite First Bank's contention, there was substantial evidence presented that it manipulated the process to ensure gains in excess of those contemplated by the Note, namely, by double-discounting its bid, which it knew was the only bid at the foreclosure sale. *Id.* While First Bank claims that it was only taking actions "expressly authorized by and provided for in the loan documents," the duty of good faith and fair dealing is inherent in every contract, and need not be expressly stated. *See Lake Contrary Sewer Dist.*, 251 S.W.3d at 369.

First Bank does not want to face the facts in this case. Its behavior was a breach of the duty of good faith and fair dealing, as is present in every contract.

B. The good faith and fair dealing instructions follow the substantive law and are readily understood.

First Bank also takes issue with the language of the instruction. "The test of a . . . not-in-MAI instruction is whether it follows the substantive law and can be readily understood by the jury." *Smith v. Kovac*, 927 S.W.2d 493, 497 (Mo. App. E.D. 1996). First Bank challenges language without providing a reason that a person would not understand the instruction.

The instruction defining "good faith and fair dealing" is not vague. L.F. 934. The language tracks the definition of the duty of good faith and fair dealing cited by both parties: that it imposes an obligation "to prevent 'opportunistic behavior, that is, the exploitation of changing economic conditions to ensure gains in excess of those reasonably expected at the time of contracting.'" *Respondent's Brief* at p. 48 (emphasis in brief); *see also Appellant's Brief* at p. 52. The instruction follows the substantive law. The language is also readily understood by the jury by itself and, importantly, through the facts presented that showed the ways in which First Bank employed opportunistic behavior to exploit changing economic conditions to ensure gains in excess of those reasonably expected at the time of contracting.

The judgment should be reversed and the cause remanded for trial with Fischer & Frichtel entitled to instructions on the duty of good faith and fair dealing.

IV. THE COMMERCIAL FRUSTRATION DOCTRINE IS RECOGNIZED IN MISSOURI AND THE DEFENSE INSTRUCTION FOLLOWED THE LAW AND WAS READILY UNDERSTOOD.

A. The commercial frustration defense exists in Missouri and is supported by the evidence

First Bank argues that the commercial frustration doctrine has only been recognized in one published appellate case in Missouri, and therefore it should not be applied here. *Respondent's Brief* at p. 57. The doctrine is recognized in Missouri and First Bank does not distinguish *Howard v. Nicholson*, 556 S.W.2d 477 (Mo. App. 1977). Instead, it recites other cases where Courts refused to apply the doctrine, none of which dealt with the economically-induced commercial frustration present in both *Howard* and this case. *See Adbar, L.C. v. New Beginnings C-Star*, 103 S.W.3d 799 (Mo. App. E.D. 2003) (refusing to excuse tenant from lease because of difficulty obtaining occupancy permit); *Kassebaum v. Kassebaum*, 42 S.W.3d 685 (Mo. App. E.D. 2001) (finding contract for sale of home valid although deeds erroneously recorded); *Am. Laminates, Inc. v. J.S. Latta, Co.*, 980 S.W.2d 12 (Mo. App. W.D. 1998) (finding insufficient evidence presented on reasons for contract termination); *Shop 'N Save Warehouse Foods, Inc. v. Soofer*, 918 S.W.2d 851 (Mo. App. E.D. 1996) (refusing to excuse lessor that contracted in violation of another tenant's restrictive covenant). First Bank characterizes the commercial frustration doctrine as a "creat[ing] new law," however, not one of these Courts held that the doctrine did not exist or was rejected in Missouri; instead, they held

that, under the facts of each case, it did not apply. The commercial frustration doctrine defense is alive in Missouri and should be applied under these facts.

First Bank also perverts the commercial frustration law by arguing that Fischer & Frichtel seeks creation of "new law" that "would excuse a borrower from its obligation to repay a lender if the housing market or the economy does not perform as well as a borrower had hoped." *Respondent's Brief* at p. 58. The law provides a defense if an event unforeseen by both parties to a contract occurs. *Howard*, 566 S.W.2d at 481. There was substantial evidence presented that neither party foresaw the economic downturn of extreme nature. Tr. at 242:6-10. Further, the doctrine does not apply in all instances of economic downturn. Fischer & Frichtel presented substantial evidence of the specific nature of the effect that the downturn had on this particular development. *Appellant's Brief* at p. 64-66. First Bank's characterization of the law and evidence is unsupported.

Further, First Bank argues that the evidence in support of the instruction "is immaterial and certainly was not unexpected." *Respondent's Brief* at p. 59. The fact of the "preferred builder" condition was known to the parties, but its *effect* on the sales of lots during the economic downturn was not. Tr. at 223:8-14. Likewise, the fact that the homes to be built on the lots were high-end homes particularly affected the sales. Tr. at 221:19-222:3. This effect could not have been known to the parties. Even the First Bank vice president testified that, in his experience, there had not been a more significant downturn in home sales. Tr. at 134:12-135:14; 182:22-25.

Moreover, Fischer & Frichtel's revenue has no place in this appeal.[5] The only question is whether, under the commercial frustration standard, the purpose of the contract was destroyed by an unforeseen event. *See Howard*, 556 S.W.2d at 481. The Note's purpose was to sell lots and pay down the Note exclusively through lot sales. Tr. at 136:10-13; 210:13-211:3; 212:1-4; 214:12-22; 217:9-14. That purpose was destroyed by the economic downturn.

Finally, First Bank attempts to inject uncertainty into the commercial frustration standard by speculating unseen possibilities. Fischer & Frichtel did not seek to have the jury determine those issues. It only sought to have the jury determine whether the unforeseen economic downturn affected the St. Albans subdivision and destroyed the Note's purpose. The *Howard* Court has already shown that unforeseen economic conditions excuse performance under the commercial frustration doctrine. Fischer & Frichtel sought evaluation under that standard.

B. The "commercial frustration doctrine" instruction follows the substantive law.

First Bank argues that the commercial frustration instruction does not provide adequate guidance to the jury. A not-in-MAI instruction must follow the substantive law and be readily understood. *Smith*, 927 S.W.2d at 497. The instruction follows the substantive law: if the occurrence of an event, not foreseen by the parties and not caused

[5] First Bank ignored evidence that Fischer & Frichtel lost $3 million the year the Note matured. Tr. at 260:12-17.

by or under the control of either party, destroys or nearly destroys the value of the performance or the object or purpose of the contract, then the parties are excused from further performance. *Howard*, 556 S.W.2d at 481. The instruction used the same standard and tracked the substantive law. *See* L.F. 932. There was sufficient evidence presented for the jury to determine that the elements were satisfied. *See Appellant's Brief* at p. 64-66. The jury was capable of understanding these terms, by themselves or in the context of the evidence presented. First Bank's arguments otherwise are deliberate obfuscation. The judgment should be reversed and the cause remanded for trial with Fischer & Frichtel entitled to a commercial frustration defense instruction.

CONCLUSION

WHEREFORE, the Circuit Court's judgment granting First Bank's Motion for New Trial or to Amend Judgment should be reversed and remanded with instructions to enter judgment on the jury's verdict less the interest awarded. In the alternative, if the Court affirms the Circuit Court's grant of a new trial, this Court should remand with instructions to submit Fischer & Frichtel's Affirmative Defenses based on the duty of good faith and fair dealing and doctrine of commercial frustration to the jury.

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that on the 4th day of November, 2011, this Appellant's Substitute Reply Brief and Appendix thereto were filed with the Clerk of the Court using the electronic-filing system. Pursuant to Rule 103.08, service on registered users will be accomplished by the electronic-filing system. I understand that at least one attorney of record for each party is a registered user.

/s/ R. Thomas Avery

RULE 84.06(c) CERTIFICATE

Pursuant to Rule 84.06(c), the undersigned hereby certifies that Defendant/ Appellant's Substitute Reply Brief contains 7,728 words, exclusive of the cover, certificate of service, this certificate, signature block, Table of Contents and Table of Authorities, according the word-processing system's word count, and thus, complies with Supreme Court 84.06(b).

/s/ R. Thomas Avery