Not for Publication

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

In re

EAST HILL MANUFACTURING CORPORATION,

Debtor.

Case No. 97-11884
Chapter 11

EAST HILL MANUFACTURING CORPORATION,

Plaintiff,

vs

EDWARD J. GROSSI and CHARTER ONE BANK, f/k/a Albank FSB, f/k/a Marble Bank,

Defendants.

Adversary No. 99-1014

#14-1
#15-1

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JUL 18 2000
FILED BY
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Hon. Robert E. Littlefield, Jr., U.S. Bankruptcy Judge

MEMORANDUM-DECISION AND ORDER

The current matter before the court is plaintiff's objection to the claim of Albank. The matter is within the court's jurisdiction via 11 U.S.C. §157(b)(2)(B) and §1334(b).

FACTS

The facts of this case are disclosed in the pleadings and pretrial submissions and are largely undisputed. Plaintiff East Hill Manufacturing Corporation ("East Hill" or "debtor") is a Vermont corporation doing business in Clarendon, Vermont. Defendant Albank F.S.B. ("Albank") is a New York banking corporation registered to do business in the State of Vermont. Albank F.S.B. is the successor in interest, by acquisition, to Marble Bank, formerly a banking corporation registered in the State of Vermont. On or about November 1, 1999, Albank filed in this proceeding a "Notice of Name Change" indicating that "Albank, a Division of Charter One Bank, F.S.B. has been officially changed to Charter One Bank, F.S.B."

The genesis of the matter occurred in 1991 when the debtor was formed by Edward A. Grossi ("Grossi") for the purpose of acquiring all assets of East Hill Equipment Corporation and/or John R. Smith. That transaction was consummated in June, 1991 with a down payment

of $250,000.00 and issuance by the debtor of five (5) separate promissory notes to the sellers. The notes were secured by the debtor's pledge back of the acquired assets and by a second mortgage issued by Grossi and his wife Leslie ("Grossis") on property owned by them individually.

On September 3, 1991, the debtor borrowed $50,000.00 from Marble Bank under a one year line of credit. The 1991 line of credit was subject to a blanket security agreement of the same date against all assets of East Hill and also by the personal guarantee of the Grossis, also of the same date. The 1991 line of credit was renewed in September, 1992, and again in September, 1993.

On October 14, 1992, Marble Bank, by Scott L. Dikeman ("Dikeman"), Assistant Vice President for Commercial Loans, approved a second line of credit for East Hill in the amount of $50,000.00. The terms of the loan were set forth in a commitment letter of the same date, which was countersigned by the Grossis individually, and by Grossi as President of the debtor on October 26, 1992.

On November 12, 1992, in accordance with the loan commitment letter of October 14, 1992, the second line of credit of $50,000.00 was borrowed by the debtor. The debtor and the Grossis signed the note for the second line of credit as makers, and the Grossis gave the Bank a second mortgage on their residence in Proctor, Vermont

as security therefor. The second line of credit, as with the first line of credit, was for a term of one year. The second line of credit came due for the first time on November 12, 1993, and it was renewed at that time for an additional one year period. The original note was stamped by Marble Bank as "Paid by Renewal."

In December, 1993, while both lines of credit were outstanding, the debtor, and the Grossis, jointly, borrowed monies from John Norton-Griffiths ("Norton-Griffiths") for use by the debtor in its business.

On September 3, 1994, the debtor's first line of credit was paid in full. In October, 1994, Norton-Griffiths filed suit in state court against the debtor and the Grossis to collect the sums due to him. The suit was stayed as against the debtor as of October 7, 1994, when it filed its first Chapter 11 proceeding.

While the first Chapter 11 case was pending, the second line of credit came due. Grossi and Dikeman discussed another possible renewal of the second line of credit and, by letter dated December 19, 1994, Grossi, on behalf of the himself and the debtor, wrote to Dikeman requesting that the Bank renew the second line of credit for an additional 6 months. In response to this request, on December 20, 1994 Marble Bank sent to Grossi a November 12, 1994 promissory note with a six month term. This Promissory Note renewed the second line of credit evidenced by the November 12,

1993 Promissory Note, signed by the Grossis, individually, and Edward Grossi as president of the debtor.

In addition, the new note was stamped with the legend "This promissory note Represents the Refinancing of Existing Indebtedness And Does Not Involve The Advancement Of New Funds. This Promissory Note Is A Refinance Of Account No. 619035018 As Evidenced By A Previous Note Dated 11/12/1993."

By letter dated January 6, 1995, Grossi returned the executed 1994 Promissory Note to Dikeman, along with a check for the December and January payments. The check had been signed by the Grossis, individually. Grossi did not execute on behalf of East Hill because of the need for Bankruptcy Court approval. No such approval was ever sought.

To satisfy the Grossis obligations to Norton-Griffiths, Grossi negotiated with Norton-Griffiths to transfer the Grossi stock ownership in East Hill to Norton-Griffiths. This transfer was completed in April, 1995, and the Grossis had no further ownership interest or connection with the debtor.

The second line of credit, as renewed by the November 1994 note remained unpaid and Marble Bank entered into a work-out agreement with the Grossis to allow them to make payments on the sums due. The agreement specifically reserved the rights of Marble Bank to collect what it could from the debtor against the sums

still owed on the second line of credit as evidenced by the 1993 Note.

In the first bankruptcy proceeding, Marble Bank filed a proof of claim, which was rejected as being untimely. This became irrelevant, however, because the debtor was unable to confirm a Chapter 11 plan and the bankruptcy case was dismissed.

On December 12, 1997, however, an involuntary petition under Chapter 7 was filed against the debtor. The involuntary proceeding shifted from an involuntary to a voluntary Chapter 11 on May 18, 1998. Marble Bank timely filed a proof of claim in the second Chapter 11 proceeding, to which the debtor has objected.

DISCUSSION

East Hill's objection to Albank's claim is based on theories of novation and/or violation of the statute of frauds.

As a starting point, "a proof of claim, executed and filed in accordance with the [bankruptcy] rules shall constitute *prima facie* evidence of the validity and amount of the claim." Fed. R. Bankr. P. 3001(f). The burdens associated with the claims objection process has been described as follows:

> [A] claim that alleges facts sufficient to support a legal liability to the claimant satisfies the claimant's initial obligation to go forward. The burden of going forward then shifts to the objector to produce evidence sufficient to negate the *prima facie* validity of the filed claim. It is often said that the objector must produce evidence equal in force to the *prima facie* case.

In re Allegheny Intern, Inc. 954 F. 2d 167, 173 (3rd Cir. 1992)(citations omitted).

A) NOVATION

Black's Law Dictionary defines novation as a substitution of new contract between same or different parties; the substitution of a new debt or obligation for an existing one; the substitution by mutual agreement of one debt for another or of one creditor for another; whereby the old debt is extinguished [citations omitted]. BLACK'S LAW DICTIONARY (1212) (4th ed. 1968)

In the present case, East Hill's novation hypothesis is centered around Marble Bank's acceptance of the November 12, 1994 promissory note executed solely by the Grossis in their individual capacities, together with payments tendered by the Grossis [plaintiff's proposed findings of fact and conclusions of law p. 14]. East Hill argues that this new note extinguished its liability on the renewed 1993 note which is the basis for Marble Bank's (now Albank's) proof of claim.

The debtor relies on the case of *In re Shatney*, 1997 WL 362767. [Trial Transcript p. 136, 138]. *Shatney* was apparently a request for declaratory judgment submitted to Judge Conrad to determine whether 34.3 acres of land belonging to the debtors, an elderly couple in Chapter 12, served as additional security for a debt of their children. Years prior to filing, the *Shatney* debtors,

in an effort to assist their children take over the family farm, cosigned a note and put up some of their realty as collateral for the children's bridge loan financing. The loan became due within 2 months at which point the debtors no longer wished to be obligated on the children's debt. A new note was executed by the children only, not by the debtors. Finding that the first loan was paid in full based on bank records and that the debtors did not sign any of the later notes, Judge Conrad concluded that the bank was required to discharge the mortgage given by the debtors in connection with the earlier bridge loan.[1]

The Vermont Bankruptcy Court has had occasion to discuss the concept of novation in the past. In *Glinka v. FDIC* (In re *Hawkins*), 156 B.R. 745 (Bankr. D. Vt. 1993), Judge Conrad noted:

> [S]everal recent Federal cases have held that using a new note to settle an old debt is not a novation of the previous debt, but a renewal. In Allied Elevator, Inc. v. East Texas State Bank of Buna, 965 F.2d 34, 37 (5th Cir. 1992), the Fifth Circuit held that in Texas, "the giving of a new note for debt evidenced by a former note does not extinguish the old note unless such is the intention of the parties." In Billings v. AVCO Colorado Industrial Bank, 838 F.2d 405, 409 (10th Cir. 1988), the Court held that because paying off an old note by execution of a renewal note is "generally just a bookkeeping procedure, such a transaction would not extinguish the original note or security agreement unless the parties intended for the prior debt to be satisfied and a new debt created." See, also Cooley v. First National Bank of Louisville, 624 F.2d 55, 57 (6th Cir. 1980) (under Kentucky law, a renewal note does not

[1] Interestingly, the concept of "novation" was not even discussed in *Shatney*.

extinguish an existing obligation).

Hawkins, 156 B.R. at 748, n. 5.

In the instant case, and contrary to the plaintiff's theory, there is no evidence that the parties ever intended that East Hill be released from the liability created by the 1993 note. Specifically:

1. The 1993 note was never marked paid or returned to East Hill;

2. The bank officer and the debtor's principal (Grossi) testified there was no intent to release East Hill. Both witnesses were credible and withstood cross-examination;

3. The November 1994 note was prepared for execution by East Hill; however, Marble Bank was advised by Grossi that Bankruptcy Counsel "feels it advisable to get Court approval before I sign it on behalf of East Hill. She has requested this approval, and believes it's likely to be routinely granted since no new borrowing is involved ." (plaintiff's exhibit 24). However such relief was never sought ; and

4. In the workout agreement with the Grossis, Marble Bank specifically reserved its rights against East Hill.

Thus, the evidence does not indicate Marble Bank's (now Albank's) intent to release the debtor. *Allied Elevator, Inc. v. East Texas State Bank of Dana* 965 F.2d 34 (5th Cir. 1992)(absent a

showing of the required intent to release East Hill, the renewal note can not be considered a novation); *Frank W. Whitcomb Construction Corp. v. Cedar Construction Co.* 142 VT 541, 544 (1983)(a novation is never presumed and must, therefore, have evidentiary support).

Since the plaintiff fails in its burden of proof to demonstrate that the parties intended to release East Hill, its cause of action premised upon novation fails.

B. STATUTE OF FRAUDS

Oral contracts are, as a general rule, legally binding and carry the same rights and liabilities as written agreements. Len Young Smith & G. Gale Roberson, Business Law, UNIFORM COMMERCIAL CODE 3rd. Ed. p. 190 (1971). The main exception to this principle is contained within the statute of frauds.

> The requirement that certain kinds of contracts must be in writing to be enforceable is traced back to 1677, when the English Parliament passed legislation requiring that certain classes of contracts be in writing, "signed by the party to be charged," before an action could be brought on them. This was part of a comprehensive statute, entitled "An Act for Prevention of Frauds and Perjuries," designed to prevent fraud and perjury in the proof of various kinds of legal transactions. Sections 4 and 17 of this "Statute of Frauds," as it came to be called, pertained to contracts, and these provisions have been substantially reenacted in almost every State in this country. Although the word "Frauds" is contained in the commonly accepted name of the Statute, it should be borne in mind that the Statute does not directly pertain to fraud, but only to formal requirements necessary to the enforceability of certain types of contracts. *Id.*

The State of Vermont's adaptation of the Statute of Frauds is contained at 12 V.S.A. §181 and provides:

Agreements required to be written

> An action at law shall not be brought in the following cases unless the promise, contract of agreement upon which such action is brought or some memorandum or note thereof is in writing, signed by the party to be charged therewith or by some person thereunto by him lawfully authorized:
>
> (1) A special promise of an executor or administrator to answer damages out of his own estate;
>
> (2) A special promise to answer for the debt, default or misdoings of another;
>
> (3) An agreement made in consideration of marriage;
>
> (4) An agreement not to be performed within one year from the making thereof;
>
> (5) A contract for the sale of lands, tenements or hereditaments, or of an interest in or concerning them. Authorization to execute such a contract on behalf of another shall be in writing;
>
> (6) An agreement to cure, a promise to cure, a contract to cure or warranty of cure relating to medical care or treatment or the results of a service rendered by a health care professional which shall mean a person or corporation licensed by this state to provide health care or professional services as a physician, dentist, registered or licensed practical nurse, optometrist, podiatrist, chiropractor, physical therapist or psychologist, or an officer, employee or agent thereof acting in the course and scope of his employment.
>
> (7) An agreement to cure, a promise to cure, a contract to cure or warranty of cure relating to medical care or treatment rendered by a health provider, which shall mean a corporation, facility or institution licensed to provide health care as a hospital.
>
> 12V.S.A. §181.

East Hill's statute of frauds theory has two prongs:

1) East Hill cannot be held answerable for the Grossis' sole liability on the November 12, 1994 promissory note because it was

not a signatory to the loan and there is no writing evidencing an authorized act of the corporation to assume the Grossis' personal liability for this debt;

2) The Vermont Statute of Frauds also bars the November 12, 1992 promissory note *ab initio* because it was a personal loan by Albank to the Grossis as it was made solely on Mr. Dikeman's own authority without any evidence that he had sought and obtained the approval of a senior lender to exceed the existing $50,000.00 outstanding loan to East Hill.

The first supposition does not apply because Albank's proof of claim is based on the 1993 note, not the 1994 note. As the Bank stated in its memorandum of law "Obviously, since there is a note signed by the Debtor, there is no defense to the action under the Statute of Frauds." [Defendant's Memoranda of Law p. 8]

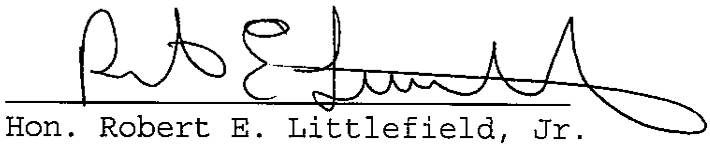
East Hill's second prong seems to hint at some infirmity in the 1993 note because it was approved by a bank officer without the countersignature of a second bank official. East Hill offers no case law for this proposition and barely develops any legal argument on it. Once again, the statute of frauds does not come into play for the 1993 note was executed by the debtor.

Thus, the alternate count to plaintiff's objection to claim fails to persuade the court.

WHEREFORE the objection to the proof of claim of Albank is overruled.

It is so ORDERED.

Dated: July 7, 2000



Hon. Robert E. Littlefield, Jr.
United States Bankruptcy Judge

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