

BORROWER'S FRAUD CLAIMS NOT BARRED BY RES JUDICATA

The U.S. Court of Appeals for the Seventh Circuit recently reversed a trial court order determining that res judicata barred a borrower's fraud claims against a bank.

In so ruling, the Court held that res judicata should not apply in this case because in the first action the borrower was a defendant and raised the fraud claim before the bank voluntarily dismissed the case when the borrower learned of the fraud claims and threatened to allege them against the bank.

A copy of the opinion in *Doherty v. Federal Deposit Insurance Corporation* is available at: [Link to Opinion](#).

A borrower and his business partner formed a company with the help of a loan from a bank. The borrower and his partner personally guaranteed the loan. The company defaulted on the loan and the bank sued the company, the borrower, and his partner in Illinois state court.

The borrower retained counsel to defend him and the company. The borrower raised several affirmative defenses to the complaint including "that the bank extended the maturity date of the loan without authorization that the bank charged fees and an interest rate not agreed upon, and that the bank charged excessive fees."

The borrower's business partner never appeared. The trial court eventually entered a default judgment against the business partner.

The borrower obtained an expert report concluding "that his signature had been forged on loan extension paperwork in 2010." The borrower sent the report to the bank's counsel, stating that he would file a suit against the bank alleging fraud. Soon after this, the bank moved to voluntarily dismiss its claims against the borrower and the company without prejudice and the trial court granted the motion.

A little over a year later, the borrower sued the bank for fraud and other related claims alleging that he did not learn of the fraud in the first action in time to raise the claims before the bank dismissed the case.

The bank moved to dismiss the second action on res judicata grounds. The trial court granted the motion finding that the borrower should have brought his fraud claims in the first action.

The borrower appealed, but before the Illinois Appellate Court heard the appeal, the bank was placed into federal receivership and the receiver removed the action to the U.S. District Court for the Northern District of Illinois under 12 U.S.C. § 1819(b)(2)(B). The trial court adopted the Illinois trial court's opinion and this appeal followed.

As you may recall, Illinois allows a plaintiff to voluntarily dismiss their claim before the trial begins without prejudice. 735 Ill. Comp. Stat. 5/2-1009(a). Such a dismissal without prejudice does not involve a “final decision on the merits and that the plaintiff is not barred from refileing the action.” When a plaintiff voluntarily dismisses their claims against a defendant, this action “does not dismiss a pending counterclaim or third party complaint.” 735 Ill. Comp. Stat. 5/2-1009(d).

Here, the borrower styled his claims in the original action as affirmative defenses, which in Illinois a defendant must raise in their answer to the complaint. 735 Ill. Comp. Stat. 5/2-613(d). This is in contrast to counterclaims which are permissive and may be brought in a separate action. 735 Ill. Comp. Stat. 5/2-608.

The Seventh Circuit observed that Illinois has three requirements to apply res judicata to bar a subsequent lawsuit: “(1) a final judgment on the merits ... entered in the first lawsuit by a court of competent jurisdiction; (2) an identity of causes of action exists; (3) the parties or their privies are identical in both lawsuits.” Illinois courts apply res judicata broadly to what was decided in the original action, and “to matters which could have been decided in that suit.”

The Seventh Circuit found **the majority of Illinois cases the trial court relied upon to conclude that RES JUDICATA BARRED THE BORROWER'S CLAIMS INAPPOSITE BECAUSE THEY “INVOLVE A SITUATION IN WHICH A PLAINTIFF IN THE FIRST ACTION ATTEMPTS TO BRING THE SAME OR SIMILAR CLAIMS IN A LATER ACTION — NOT A SITUATION IN WHICH A DEFENDANT TO THE FIRST ACTION BRINGS AFFIRMATIVE DEFENSES AS INDEPENDENT CLAIMS IN THE SECOND ACTION.”** Nor does this appeal involve a final judgment in the first action that addressed the affirmative defenses that the borrower raises in the second action.

The Seventh Circuit reasoned that it was appropriate to apply the principles of equity in Illinois law to this case to allow the borrower to prosecute the second action for several reasons. The borrower properly raised his affirmative defenses to the bank's claims in the first action.

The bank obtained a default judgment in the first action against a defendant different from the borrower. The borrower then produced a handwriting expert report and based on this report threatened to sue the bank for fraud. In response, before the borrower brought any fraud claim against the bank in the first action, the bank dismissed its claims against the borrower without prejudice.

As a result, **the bank never defended against the fraud claims in the first action and the default judgment against a different defendant should not bar the borrower from pursuing his fraud claims against the bank in the second action.**

The Seventh Circuit also determined that applying the doctrine of res judicata here would not advance the purposes behind the doctrine.

Res judicata is designed “to prevent a second litigation from undermining the prior judgment.” Here, if the borrower prevails on his fraud claims against the bank in the second action, it will not give the borrower standing to challenge the default claim in the first action against a separate defendant. Indeed, the borrower’s second action only “seeks redress for the bank’s alleged fraud but does not challenge the default judgment entered” against the separate defendant in the first action.

There is also no concern here about claim splitting according to the Seventh Circuit because **the borrower was a defendant in the first action and did not dismiss the first action.**

Finally, the Seventh Circuit believed that applying the doctrine of res judicata here would not serve the interests of judicial economy. **The court in the first action “never considered or weighed in on” the borrower’s fraud claims because the bank dismissed its claims against the borrower without prejudice. The bank never litigated the fraud claim in the first action and defending against this claim in the second action “will not force the bank into redundant litigation.”**

Thus, the Seventh Circuit reversed the trial court order determining that res judicata barred the borrower’s claims and remanded for further proceedings consistent with its opinion.