

Current Developments



in

Lender Liability Law

Web Conference Series

Lender Liability Issues and Prevention



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Lender-Borrower Events

- Loan Origination
- Loan Administration
- Restructure of Distressed Loans
- Foreclosure
- Bankruptcy





Traditional Theories of Liability

- Breach of Contract
- Fraud and Duress
- Negligence
- Conversion
- Defamation
- Infliction of Emotional Distress
- Statutory Liability



Breach of Contract

- Loan Commitments
- Refusal to Advance Funds
- Improper Acceleration and Demand
- Failure of Adequate Notice
- Failure to Provide New Financing
- Failure to Restructure
- Oral Contract



Fraud and Duress

- Actual Fraud
- Constructive Fraud
- Threats to Reputation, Business or Property Interests
- Economic Duress
- Equitable Duress to Defeat Lender's Defenses or Counterclaims





Developing Theories of Lender Liability

- Constructive Fraud - Fiduciary Duty
- Good Faith and Fair Dealing
- Improper Control Over Borrower
- Interference with Borrower's Prospective Business Advantage
- Interference with Borrower's Contractual Relations



Constructive Fraud Based on Fiduciary Duty

- A lender who only acts as a lender cannot be a fiduciary
- Unilateral expressions of a borrower do not change the relationship, BUT
 - If a loan officer gives business advice to borrower
 - If a borrower shares confidential information with the lender and lender uses that information
 - If the borrower puts “trust and confidence” in lender
- Then a Fiduciary Relationship might arise



Good Faith and Fair Dealing

- Good Faith and Fair Dealing is implied in every contract
 - But cannot create rights that do not exist in the four corners of the contract
- Good Faith and Fair Dealing means the lender must act reasonably in asserting its rights under the contract
 - Objective Standard



Improper Control

- Construction lending
- Dominion over management
- Control over operations
 - Withholding or reducing advances



Interference with Business Advantage or Contract

- Tort claim with punitive damages
- Advantage must be actual, not just borrower's expectation
- Requires an independent wrong by lender and lender's knowledge that action is substantially certain to disrupt economic relationship



GOVERNMENT TELEGRAPH SERVICE
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TELEGRAM

To:
DESIGNATED AGENT



Charges.....



Loan Origination Issues

- Applications
- Commitment
- Documentation and Closing
- Disclosure of Adverse Information



Application and Commitments

- Handling of application and commitment to extend credit
- Lender owes the borrower a duty of reasonable care to act without delay
- Lender may have duty to process if a prior relationship exists
- Acceptance of a fee creates a contract to process the application



Loan Application Cases

- Both contract and tort damages, including punitive damages, available for failure to process application with due care after accepting fee
 - *Jacques v. First Nat'l Bank*, 515 A2d 756 (Md Ct App 1986)
- Lender liable where borrower takes further steps on project while application pending
 - *Landes Constr. Co. v. Royal Bank of Canada*, 833 F2d 1365 (9th Cir 1987)



Loan Commitment Cases

- Lender refusal to fund construction loan because Borrower failed to deposit funds and post a completion bond resulted in jury verdict of \$18.6 million. Second trial found breach, but awarded \$1 in damages
 - *Lester v Resolution Trust Corporation*, 994 F2d 1247 (7th Cir 1993)
- Lender bound by loan officer who issues unauthorized commitment letter
 - *Pipken v. Thomas & Hill*, 258 SE2d 778 (NC 1979)



Documentation/Closing Cases

- Lender liable for damages for including prepayment penalty clause not present in loan commitment
 - *999 v. CIT Corp.*, 776 F2d 866 (9th Cir 1985)
- Lender awarded damages for borrower's failure to negotiate terms of final loan in good faith
 - *Teachers Ins. & Annuity Ass'n v. Butler*, 626 F Supp 1229 (SD NY 1986)



Disclosure of Adverse Facts

- If a lender communicates any facts, communicate all material facts
- Lender liable to borrower's supplier for negligently responding to a credit inquiry about borrower
 - *MSA Tubular Prods. Inc. v. First Bank & Trust Co.*, 869 F2d 1422 (10th Cir 1989)
- Adverse material facts must be disclosed to guarantor
 - *Barrett v. Bank of America*, 183 Cal App 3rd 1362 (1986)



Loan Administration

- Communication with Borrower
 - Avoid Creating Special Relationships
- Notice of Change in Administration
- Control and Interference



Notice of Action

- Borrower awarded \$7.5 million because lender breached covenant of good faith and fair dealing for failure to give sufficient notice before refusing to advance funds up to maximum limit of revolving line of credit
 - *KMC Co. v. Irving Trust Co.* 757 F2d 752 (6th Cir 1985)



Control and Interference

- Construction loan agreement permitting lender to oversee construction with express oversight of the project was solely for lender's benefit and does not create additional responsibility or liability

Alpine Bank v. Hubbell, 555 F3d 1097 (10th Cir. 2009)



Control and Interference

- Court rejected lender's argument that conditions precedent for funding and inspection of progress of construction loan are conditions to funding which exist solely for benefit of lender and can be waived

LaSalle Bank National Assn. v. Paramount Properties, 588 F Supp 2d 840 (ND IL 2008)



Control and Interference

- Lender group found liable for fraud and civil conspiracy for threatening to invoke change in management clause, declare a default, and put the borrower into bankruptcy in order to affect selection of future CEO
 - *State National Bank of El Paso v. Farah Manufacturing Co.*, 678 SW 2d 661 (Tex Ct App 1984)



Distressed or Troubled Loans

- Notice of Defaults/Acceleration
- Restructure Negotiations
- Foreclosure Issues
- Bankruptcy



Default

- Liability for calling “demand” notes where the borrower had not yet failed to meet the installment obligations
 - *Bank One, Texas, N.A. v. Taylor*, 970 F2d 16 (5th Cir 1992)
- \$6 million verdict for refusal to renew line of credit, freezing accounts and applying funds to outstanding balances of “troubled” loan
 - *FDIC v. Perry Brothers*, 854 F Supp 1248 (ED TX 1994) aff'd in part vacated and remanded 68 F3d 466 (5th Cir 1995)



Acceleration

- Jury to decide whether lender failed to exercise good faith in accelerating a loan based on contentious history between the lender and borrower and on declaration of default for payment received one day late
 - *Sahadi v. Continental Illinois Nat'l Bank and Trust Co.*, 706 F2d 193 (7th Cir 1983)



Restructure Agreements

- Lender liable for negligent misrepresentation because loan officer indicated that bank was willing to negotiate a restructure, despite documents in bank files that proved bank had already decided to disengage
 - *Richter v. Bank of America*, 939 F2d 1176 (5th Cir 1991)



Foreclosure

- Lender estopped from proceeding with foreclosure because lender accepted payments without qualification as to application of funds
 - *Tully v. World Sav. & Loan Ass'n*, 56 Cal App 4th 654 (1997)
- Election of remedies: trustor may sue in equity to set aside the sale or for damages



Bankruptcy

- Avoidance Actions
 - Preferential transfers
 - Fraudulent transfers
 - Collateral surcharge
- Violations of the automatic stay
- Equitable subordination



Equitable Subordination

- Standard shifts depending on status of offending party
 - Ordinary Creditors - party seeking subordination must prove egregious misconduct tantamount to fraud
 - Insider/Fiduciary - insider has the burden of proof of legitimacy and arms length character of transactions



Equitable Subordination

- Ordinarily, a lender will not be considered a fiduciary or an insider.
 - *In re Teltronics*, 29 B.R. 139 (Bankr ED NY 1983)
- A lender that makes decisions that the borrower's directors and officers typically make might assume the fiduciary obligations of insiders
 - *In re Badger Freightways*, 106 B.R. 971 (Bankr ND IL 1989)



Equitable Subordination

- A lender that uses leverage to take over operation of the company may become a fiduciary
 - *In re Auto Specialties Mfg. Co.*, 153 B.R. 457 (Bankr WD Mich 1993)



Equitable Subordination

- Court refused to dismiss equitable subordination claims against lender that held two seats on board of directors, controlled the board's ability to obtain a quorum, and had significant rights as a preferred shareholder
 - *Markettxt Holdings Corp. v. Softbank AM Corp.*, 361 B.R. 369 (Bankr SD NY 2007)



Written Credit Agreements

- A majority of states have adopted Lender Protection statutes
- Oral agreements must be reduced to a writing and signed by the lender
- Precludes many types of borrower claims or defenses
 - See e.g., *General Electric Capital Corp. v. Donogh Homes, Inc.*, No. 93 C 5614, 1993 US Dist LEXIS 17690 (ND IL Dec. 14, 1993)



Credit Agreement Statutes

- Borrower's claims barred despite borrower full performance under the oral agreement
 - *Machinery Transports of Illinois v. Morton Community Bank*, 293 Ill App 3d 207 (3rd Dist 1997)
- Borrower's claims barred where lender failed to extend credit based on oral agreement
 - *Help at Home, Inc. v. Medical Capital, LLC*, 260 F3d 748 (7th Cir 2001)



Credit Agreement Statutes

- Borrower's claim barred where lender failed to advise a borrower that it was reducing available credit and deleting certain inventory from borrowing base
 - *VR Holdings, Inc. v. LaSalle Business Credit, Inc.*, No. 01 C 3012, 2002 US Dist. LEXIS 3654 (ND IL Mar. 5, 2002)



Tips to Avoid Liability Claims

- Follow your policies and procedures
 - Review and update the manual regularly
 - Train your loan officers and personnel who have contact with borrowers
 - Make certain that exceptions are well documented in a file memo
 - Obtain all requisite internal approvals before taking action
 - Have borrower sign and initial all documents



Tips to Avoid Liability Claims

- Avoid oral promises, representations, modifications and waivers
 - Have a letter agreement signed by the borrower that expressly states that negotiations are not binding
 - All agreements must be reduced to a signed and written document
 - In-person meetings with the borrower should be attended by at least two bank personnel



Tips to Avoid Liability Claims

- Prepare file memos on a regular basis
 - Make sure they are professional, unbiased, and accurate
 - Do not use nicknames or derogatory comments, especially in email
 - Communicate with the borrower early and often to avoid misunderstandings and surprises
 - Audit loan files



Tips to Avoid Liability Claims

- Avoid “Control” Issues
 - Do not actively participate in the management of the borrower’s business
 - Do not instruct the borrower about which trade creditors should and should not be paid
 - Do not make representations to the borrower’s trade creditors that would induce them to extend additional unsecured credit
 - Follow your policies and procedures regarding information that can be disclosed to third parties



Tips to Avoid Liability Claims

- Give Notice
 - Before taking any action that might impair the borrower's operations or finances
 - Act on short notice only when absolutely necessary to ensure repayment
 - Stay the course – even in violation of the loan agreement – until you give notice know that you are changing the “rules”



Tips to Avoid Liability Claims

- Assess the risks of a claim
 - Avoid action where the risk of loss on a claim greatly exceeds the risk of nonpayment or impairment
 - Examine all documentation and correspondence with the borrower
 - Consult with all personnel having interaction with the borrower to assess lender liability risks

Further Questions ?



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