Defending Lender Liability Claims Under the Common Law

By Daniel B. Moar

While the Great Recession officially ended years ago, enduring roller coaster economic conditions mean that lenders continue to face many legal claims from borrowers looking to compromise or erase debts. Lender liability claims frequently increase where volatile economic conditions lead to a rise in borrower defaults and less willingness by lenders to offer additional credit. Often the borrowers have failed to pay back loans and use litigation to claim that the lender was really to blame for a default. While lender liability claims frequently are unsuccessful, lenders can incur substantial defense costs and face business disruption.

Lender liability suits generally involve claims that lenders either (a) failed to provide or fund a loan; (b) caused the project subject to the loan to fail; or (c) failed to perform in accordance with loan documents or the covenant of good faith and fair dealing. Borrowers assert a variety of common law claims including for breach of contract, breach of fiduciary duty, tortious interference, and “control” liability. This article explains the basics of each of these claims and steps that lenders can take to minimize the likelihood of litigation and liability.

Breach of Contract

Borrowers frequently assert liability against lenders based on breach of a loan agreement. Some of the more common claims are that the lender failed to honor a loan commitment letter, failed to extend a loan, failed to honor an alleged modification to a loan agreement, or failed to comply with the written requirements of a loan agreement.

In one recent case, for example, a borrower sued a lender for failure to advance funds to be used on a construction project. The loan agreement, however, gave the lender discretion to determine when to make loan disbursements. The court granted summary judgment to the lender in reliance on the express language in the agreement explicitly granting the lender discretion.

Where the terms of the loan agreement lack such clarity, courts have come to different outcomes. For example, in another case, a borrower brought suit claiming that a bank had improperly refused to provide financing that it had promised. The borrower had a pre-existing $16,100,000 loan with the bank and alleged that, upon execution of this loan, a bank officer had promised to provide at least $39 million in further financing to be used to develop a residential housing complex. The borrower alleged that in reliance on this promise it continued to spend millions of dollars from its own pocket to develop the housing complex and that it was injured when the borrower refused to provide the additional financing. The court found that this alleged reliance was sufficient for the borrower to pursue a claim for breach of contract against the bank.

Even where there is no claim of breach of the explicit requirements of a loan agreement, borrowers may nonetheless allege that a lender’s conduct constitutes a breach of the implied covenant of good faith and fair dealing. Under the implied covenant, neither party to the agreement may take actions that, while not expressly prescribed by the agreement, in effect defeat the ability of the other party from receiving the benefit of the agreement.

A lender is generally not liable for breach of the implied covenant where the lender’s alleged “breach” is allowed by the express terms of the loan agreement. “Put simply, a party does not breach an agreement by behaving as the instrument permitted.” For example, where a loan arrangement granted the lender discretion on how much money to advance to the borrower, the lender was not liable for breach of the implied covenant when it declined to advance the maximum amount allowed. Similarly, where a loan agreement granted a lender discretion as to whether to make additional loans, the lender is not required to do so because “[t]he implied covenant of good faith and fair dealing will not impose an obligation that would be inconsistent with the terms of the contract.” Moreover, where a lender refuses to discuss a loan modification with a defaulted borrower and instead brings a legal action to collect on the debt, the decision not to consider a modification does not amount to a breach of the covenant of good faith and fair dealing.

Breach of Fiduciary Duty

A lender-borrower relationship does not ordinarily impose fiduciary obligations upon the lender. However, where a lender steps beyond the typical lending relationship this can create fiduciary liabilities, such as where the bank acts as a financial advisor to the borrower.

To establish a fiduciary duty, courts consider the following factors: the nature of the relationship between the parties, whether the alleged fiduciary appeared to have a unique or special expertise, whether the alleged fiduciary was aware of the use to which information would be put, and the purpose for which the information was supplied. A fiduciary relationship does not generally arise when unrelated entities engage in commercial transac-

Daniel B. Moar is a partner at Goldberg Segalla, LLP where he focuses his practice on complex commercial litigation.
tions with one another, even if one party has disparate economic power, because these relationships are viewed by courts as straightforward arm’s-length relationships. A fiduciary relationship is not necessarily created even when a contract provision imposes confidential or non-disclosure obligations on the parties.

Courts commonly recognize a fiduciary relationship where a lender exercises control over an escrow account on behalf of the debtor. This fiduciary relationship, however, is narrowly tailored to claims based on the lender’s control over the escrow account, i.e., a lender can face liability if it makes unnecessary payments under the escrow account. The lender’s obligations with respect to an escrow account do not create an all-encompassing fiduciary duty on all aspects of the lender-debtor relationship.

A fiduciary relationship generally arises when one party places confidence in another, resulting in the latter party exercising superiority and influence over the former. A lender may owe a fiduciary duty to a borrower if the lender gains substantial control over the borrower’s business affairs. Control over the borrower is demonstrated when there is evidence that the lender ran the actual day-to-day management and operations of the borrower or had the ability to compel the borrower to engage in unusual transactions.

Control Liability

Lenders can also face liability to third parties when they exercise such overwhelming control over a borrower’s day-to-day operations that the lender effectively is considered to act as the borrower. Additionally, when a lender exercises day-to-day control over the borrower, this can lead to allegations of a fiduciary relationship whereby the lender becomes liable for the borrower’s failure. Finally, if a lender uses its control over a borrower as a means to preferentially repay the loan at the expense of the borrower’s other existing debts, the other creditors of the borrower can assert claims against the lender.

This does not mean a lender can take no action to try to seek repayment on a loan. Indeed, to establish liability under a control theory requires “a strong showing that the creditor assumed actual, participatory and total control of the debtor.” A lender can legitimately act to safeguard its own interests by using leverage to “recoup the most amount of money possible” and to monitor the borrower without being liable under a control theory. Control liability generally requires “complete domination” of the borrower by the creditor—“[s]uggestions by a major lender for a defaulted debtor even when coupled with a threat of the exercise of its legal rights if the debtor does not comply, are both commonplace and completely proper.”

Negligent Misrepresentation

In New York, a lender may be liable for negligent misrepresentation where it has a special relationship with the borrower. For example, in Fleet Bank v. Pine Knoll Corp., the lender acknowledged at a deposition that many of its small business customers lacked significant financial knowledge and instead relied on the advice of bank relationship managers assigned to oversee the loans. The specific loans at issue were part of a two-phase loan to be used to finance the purchase, renovation, and operation of resort property. The borrower could not perform the necessary tasks without receiving both phases of funding. While documentation existed establishing entitlement to the first round of funding, none established that the borrower would receive the second round of funding. The borrower, however, alleged that the lender’s relationship managers repeatedly promised that the second round of funding was forthcoming and encouraged the borrower’s principal to use personal assets to pay for necessary debts until the second round of funding was provided. When the second round of funding was not provided, the project fell apart. The court found the facts alleged by the borrower were sufficient for its negligent misrepresentation claim against the bank to survive summary judgment.

The requirements for a negligent misrepresentation claim, however, differ in other jurisdictions. For example, in New Jersey, courts have rejected a requirement of a special relationship to plead negligent misrepresentation. Instead “[t]o prevail on a claim for negligent misrepresentation, a plaintiff must prove: (1) defendant negligently made a false communication of material fact; (2) that plaintiff justifiably relied upon the misrepresentation; (3) the reliance resulted in an ascertainable loss or injury.”

Tortious Interference

A claim of tortious interference with a contract generally involves one of two sets of facts. First, borrowers can pursue a tortious interference claim where a lender induces a third party contracting with the borrower to breach that contract. Second, borrowers can allege tortious interference where the lender prevents the borrower from complying with a contract between the borrower and a third party. In either instance, lenders can generally avoid liability if they show a bona fide exercise of rights set forth in the loan agreement.

To prove tortious interference with contract, a borrower must show the following elements: (1) the existence of a valid contract between the plaintiff and a third party; (2) defendant’s knowledge of that contract; (3) defendant’s intentional procurement of the third-party’s breach without justification; (4) actual breach of the contract; and (5) damages resulting therefrom. The New York Court of Appeals has noted that “procuring the breach of a contract in the exercise of equal or superior rights is acting
with just cause or excuse and is a justification for what would otherwise be an actionable wrong.\textsuperscript{33} As such, under New York law, a lender’s economic interest can be utilized as a defense to a cause of action for tortious interference with a contract, unless there is a showing of malice or illegality.\textsuperscript{34}

\textbf{Minimizing Lender Liability Claims Before the Lending Relationship}

When lenders are in preliminary discussions with prospective borrowers regarding the possibility of providing a loan, lenders should clearly and expressly note in writing that a loan commitment letter or other preliminary document is subject to a definitive loan agreement. By doing so, lenders can reduce the likelihood that a borrower can claim that a preliminary agreement was in fact binding and that the lender should face liability for failure to abide by the preliminary agreement.

All final loan agreements should contain provisions prohibiting oral modifications. Additionally, any amendments to existing loan agreements should also include no oral modification language.

Lenders should also seek a personal guaranty on a loan whenever practical. A personal guaranty provides a second source to seek repayment. In addition, a personal guaranty can waive defenses and counterclaims that might be asserted by the borrower and thereby allow the lender to pursue repayment from the guarantor with a reduced risk of extensive litigation.\textsuperscript{35} Clauses imposing an absolute and unconditional repayment obligation with waiver of defenses are commonly called “hell or high water” clauses and are generally enforceable.\textsuperscript{36}

Similarly, lenders should seek a waiver of claims of a fiduciary relationship. While lenders are generally not found to owe fiduciary duties, exceptions can arise. Lenders can avoid the need for even litigating the existence of a fiduciary relationship through a waiver because “agreements to waive claims of a fiduciary relationship are permissible under New York law.”\textsuperscript{37}

\textbf{After Lending Is Provided}

A lender that has already extended a loan or line of credit should avoid making unexpected sudden moves whenever possible. This is particularly true when there is a lengthy relationship between the lender and the borrower under which a course of dealing can be seen where the lender does not demand literal compliance with the loan agreement, such as by routinely accepting late payments. In such circumstances, even if the loan agreement technically allows a lender to immediately end financing without notice to the borrower, the lender faces a substantial risk of a lender liability suit by doing so.\textsuperscript{38} Borrowers will claim reliance on the financing arrangement and will bring lender liability claims that, even if meritless, can be costly and time-consuming to defend. Thus, it is generally in the best interest of the lender to provide advance notice and documentation of any change to the lending relationship and allow a borrower to seek outside replacement financing even if the loan arrangement does not require this.

Where a borrower is clearly in a distressed state, a lender can monitor the borrower or provide unbiased information. When a lender begins to dictate that the borrower take certain actions, however, this can lead to allegations that the lender “controls” the borrower’s business and is responsible for its failures or that the lender is acting in a fiduciary role to the borrower. While the line between permissible participation and undue control can be blurry and is extremely fact specific, a lender should avoid taking steps that can be construed as amounting to day-to-day control of the borrower’s operations because that may lead to lender liability claims.

\textbf{Workouts}

When a lender is considering entering into a “workout,” which modifies the terms of a loan, the final decision as to the terms of a workout should generally be made by someone other than the original loan officer on the file. The initial loan officer obviously can contribute valuable background and input, but he or she may not be in the best position to give the loan an objective analysis. Additionally, in the event of lender liability claims, where the original loan officer also handles a later workout, the borrower can paint the loan officer as self-interested and the workout as an attempt by the loan officer to avoid being perceived internally as non-performing. Accordingly, lenders should consider employing separate specialized workout officers who are in a better position to make unbiased decisions on modifications.

A lender should also confirm all material discussions regarding a workout in writing. Such writings minimize the likelihood the borrower can either claim the lender agreed to waive its claims or agreed to a modification at odds with the actual discussion.

When workouts are sought, lenders should also obtain personal guaranties to support the modified agreement. The guaranties should expressly state that they are being given to support waiver of an existing default so that there can be no later dispute that the guaranty was provided without consideration.

Lenders will sometime face lender liability claims even after modifying the loan arrangement via a workout. Frequently lenders will agree to workouts to extend the time for a borrower to repay a loan or modify the loan terms to avoid the need to pursue a lawsuit against a borrower. Unfortunately, lenders infrequently fail to recognize the need to request a release from a borrower in exchange for agreeing to a workout.

When lenders engage in discussions with a borrower to modify a loan, part of the discussion should be a request from the lender for a release from the borrower as
to any then existing claims. By obtaining a release, the lender can generally easily avoid litigation for any claims pre-dating the workout.39

Internal Documentation

During discovery, lenders will often have to produce internal correspondence relating to a defaulted account. Employees of the lender will rarely put the same level of thought into internal email as they would to a physical letter. Instead, internal emails will sometimes reflect derogatory comments about the borrower or incorrect assumptions about the terms of a loan arrangement. Borrowers can then misuse such internal emails as supporting claims of bad faith or as evidence that the lender agreed to an oral modification.

A lender should always assume that any internal correspondence might be one day put before a jury. Accordingly, internal correspondence should be based on objective information and should avoid editorializing or stating anything that could cast the lender in a bad light.

Lenders can minimize the possibility of this by limiting email discussions about accounts and providing proper training to employees as to the use of email. Additionally, lenders can and should ensure that employees are aware that emails will be used in litigation and that employees should avoid unnecessary or uninformed commentary about lending arrangements.

After Litigation Begins

No matter how careful a lender is in structuring and administering loans, most lenders will face lender liability claims. Often, these claims will have little or no merit and will be asserted by borrowers primarily in an attempt to delay the lender from pursuing its rights to proceed against a defaulting borrower. While such litigation gamesmanship is unfortunate, lenders can take several steps to ensure that litigation proceeds as quickly as possible to a resolution.

During discovery a lender may benefit if it discovers that the borrower made misrepresentations in the initial loan application. For example, in one foreclosure action, the borrower had misrepresented his income in the initial loan application.40 When the borrower alleged lender liability claims based on the lender’s issuance of the loan without investigating the borrower’s misrepresentation of income, the court concluded that not only was the lender not liable for failure to investigate, but that the borrower’s misrepresentation amounted to “unclean hands” depriving the borrower from seeking equitable relief.41

A lender should also consider a borrower’s likely intentions in engaging in discovery. For example, where a borrower serves a mammoth amount of discovery on a lender, the lender may want to ignore the natural response of serving large discovery demands on the borrower as a tit-for-tat. Many times, the borrower is just using discovery in support of its purported lender liability claims as a delay tactic and a lender actually plays right into the borrower’s hand by also serving expansive discovery demands.

Where a lender can get past litigation, significant care should be put into drafting settlement agreements. With a settlement requiring the borrower to make payments over time, the lender should request a confession of judgment be signed by the debtor. A confession of judgment is a written acknowledgement by the debtor of the amount due. As part of a settlement agreement, a lender can agree to hold a confession of judgment in escrow and not enter it so long as the borrower makes the payments required under the settlement agreement. Thus, the confession of judgment can provide a strong incentive to a debtor to maintain payments required under a settlement agreement to avoid the entry of the confession of judgment.

Conclusion

Lenders will continue to face an increase in lender liability claims originating in the Great Recession because of delays in commencing suit and delays in ongoing litigation. Additionally, economic volatility will ensure that such claims are an enduring reality for lenders. Notwithstanding this, lenders can take steps to be proactive in minimizing the number of lender liability claims they face and reducing the likelihood of adverse judgments.

Endnotes

2. Id. at *17.
4. The Court found that the alleged reliance satisfied the promissory estoppel exception to the New Jersey statute of frauds that required agreements to lend money in excess of $100,000 to be in writing. Id. at *10-*15. Notwithstanding this decision, borrowers often fail with claims premised on reliance on oral promises because “a borrower may not properly claim to have reasonably relied on representations that are plainly at odds with the loan documents governing the terms of the loan.” Wells Fargo Bank, N.A. v. Arthur, 2016 N.Y. Misc. LEXIS 643, at *15 (Sup. Ct., Suffolk Co. Feb. 1, 2016).


13. Muller-Paisner v. TIAA, 881 F. Supp. 2d 579, 593-94 (S.D.N.Y. 2012); see also Ballard v. Hartford Life Ins. Co., 2011 Conn. Super. LEXIS 81, at *7 (Conn. Super. Ct. Jan. 18, 2011) (“The essential elements to pleading a cause of action for breach of fiduciary duty under Connecticut law are: (1) That a fiduciary relationship existed which gave rise to (a) a duty of loyalty on the part of the defendant to the plaintiff, (b) an obligation on the part of the defendant to act in good faith in any matter, relating to the plaintiff; (2) That the defendant advanced his or her own interests to the detriment of the plaintiff; (3) That the plaintiff sustained damages; and [that] the damages were proximately caused by the fiduciary’s breach of his or her fiduciary duty.”).


18. In re Bh Sutton Mezz LLC, 2016 Bankr. LEXIS 4113, at *82 (“Courts have consistently rejected… attempt[s] to impose a heightened obligation on all aspects of the debtor-creditor relationship simply because the mortgagee makes payments from an escrow account on behalf of the mortgagor.”).

19. Dolan, 2016 U.S. Dist. LEXIS 81107, at *20-*21 (“A fiduciary duty may exist in a lender-borrower relationship, but only upon a showing that the lender enjoyed an unusual advantage resulting from the confidence that [the borrower] placed in [the lender], or [a] showing that [the lender] assumed control and responsibility outside the terms provided for in the contract’ between the parties’); Bohm v. Commerce Union Bank of Tennessee, 794 F.Supp. 158, 164 (W.D.Pa. 1992).


21. Id.


27. 290 A.D.2d 792, 796, 736 N.Y.S.2d 737, 741 (3d Dep’t 2002).

28. Id. at 793.

29. Id. at 796.


36. In re Lehman Bros. Holdings, 541 B.R. at 571 (“A recent Second Circuit opinion ‘confirm[ed] that, under New York Law, hell or high water clauses are enforceable’ against ‘sophisticated parties.’ Moreover, New York courts have generally enforced these clauses, provided that their terms clearly waive the challenged defense. In fact, New York courts have specifically found that a ‘hell or high water’ clause may bar claims of lack of consideration and authority’); see also Taib Bank, B.S.C.(c) v. West End Equity I, Ltd., 2016 N.Y. Misc. LEXIS 475, at *17 (Sup. Ct., N.Y. Co. Feb. 16, 2016) (rejecting cause for fraudulent inducement because of an absolute and unconditional guaranty clause).


38. For example, in Liberty Bank v. New London Ltd. P’Ship, the court found a triable issue as to whether the bank should be estopped from pursuing a mortgage foreclosure action because the bank’s “consistent pattern of accepting late payments without protest, combined with the surrounding circumstances, provides evidence of conduct that may have induced the [borrowers] to believe in the existence of certain facts, i.e., that the [bank] would continue its collection of the debt in accordance with established past practice. In other words, based on the course of the relationship, the [borrowers] may have reasonably been led to believe that, absent some type of notice to the contrary, the [bank] would continue to be satisfied with accepting a late payment along with a late fee.” 2007 Conn. Super. LEXIS 1065, at *15 (Conn. Super. Ct. May 1, 2007).

The Second Circuit, however, rejected a claim that a bank was obligated to continue granting further extensions of credit where the borrower had received numerous prior extensions even though the borrower had repeatedly put its account into overdraft status. See Fasolino Foods Co. v. Banca Nazionale Del Lavoro, 961 F.2d 1052, 1057 (2d Cir. 1992) (“A rule that banks may not issue letters of credit to a defaulting borrower without obligating themselves to issue yet more letters in the future would help the borrower in this case but would work to the detriment of future borrowers. Such a rule would disable banks from ending risky financing relationships and cutting their losses, causing the banks either to charge greater interest to compensate for the greater risk or to be more selective in initiating financing relationships, or both.”).

39. Lenders will need to verify with counsel that a release is enforceable for the specific loan subject to the workout.


41. Id. at *13.