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Lender Liability: Avoid It Like The Plague!

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I. Key Issues in Lender Liability Today:

a. Term sheets
b. Loan commitments (misrepresentations, improper processing, discrimination)
c. Insecurity clauses and MAC clauses
d. Good faith and fair dealing (failure to renew a loan, technical defaults)
e. Excessive control of the borrower (holding shares; exercising voting control)
f. Understanding your loan documents and attention to detail
g. Complying with bank policies and procedures
h. Using forbearance agreements to limit liability (waiver of claims and defenses)
i. Personal loan guaranties, including ECOA issues

THE LENDER-BORROWER RELATIONSHIP

The lender-borrower relationship is that of an arm's length transaction. The lender provides loans, the loan documents are prepared and signed, and the borrower is subject to the terms and conditions of the loan documents. The lender provides no advice to the borrower, no consulting, and no participation in the management of the borrower. Lending officers have no fiduciary obligation to the borrower.

Commercial lenders are trained in this and are expected to act as a lender only and not as an advisor so as to avoid any perception that they are somehow acting in the best interest of the borrower. To the contrary, lenders have a fiduciary duty to their employer, to keep current on the financial condition of the bank's borrowers and to act in the bank's best interest which is to have the loans repaid while applying a prudent standard of care.

GOOD FAITH AND FAIR DEALING IN THE LENDER-BORROWER RELATIONSHIP

The obligation of good faith and fair dealing in commercial banking is a long standing one. Commercial lenders are familiar with this concept and are expected to follow it as it is an accepted practice on an industry-wide basis. Commercial lenders must make sure that not only are their actions consistent with policies and procedures and regulatory requirements, but also that no representation of the lender has, by action or conversation, induced the borrower and/or guarantor to a false sense of security.

Good faith and fair dealing actions include deception, misrepresentation, and abuse of power and position. Focus is required on the type of behavior or conduct in the loan transaction, especially when the lender has discretion over a particular issue relating to the loan. Good faith and fair

dealing in the borrower and/or guarantor relationship includes notice and communication, the extent to which a lender keeps the borrower and/or guarantor appraised of information learned or discovered by the lender and information learned by the borrower and/or guarantor to communicate to the lender. Good faith and fair dealing is a two-way street that requires that neither party should do anything to injure or damage the other side according to the terms of their agreement.

Typical Lender Liability Causes of Action

- **Breach of Contract.** A lender and borrower share a contractual relationship, which could result in a lender being held liable for breaching oral, implied and written contracts. Common breach of contract claims include assertions that a bank failed to: advance funds after a loan commitment became legally binding; extend a loan, honor a loan modification or forbear after agreeing to do so; or take actions required under loan documents or interpret loan documents properly.
- **Breach of the Implied Covenant of Good Faith and Fair Dealing.** Borrowers have also used traditional breach of contract claims to file claims based on a breach of the implied covenant of good faith and fair dealing. Some lenders have been found liable for (a) refusing to release a deed of trust in an effort to pressure the borrower into paying off another loan and (b) manipulating an appraisal of the borrower's property to cause a default.
- **Economic Duress.** Courts have distinguished between a lender (a) making threats and (b) threatening to do that which it has a legal right to do or refusing to do that which it is not legally required to do.
- **Tortious Interference with a Contract.** This can occur when a lender intentionally induces a breach of the borrower's contract with a third party.
- **Inappropriate Collateral Sales.** Lenders have had problems where they sell collateral inappropriately after a loan default. Under the UCC, the method, manner, time, place and terms of the sale must be commercially reasonable. Some courts have held that a sale is "commercially unreasonable" if the lender relied on an appraisal that it knew or should have known was too low, or provided insufficient publicity for the sale to generate a sufficient number of bids.
- **Instrumentality Theory.** A lender could expose itself to liability to the borrower and third parties where the lender exercises such control over the borrower's day-to-day business operations that, in effect, the borrower becomes an instrumentality of the lender.
- **Breach of Fiduciary Duty.** The elements to establish a fiduciary relationship between a bank and a borrower are (a) the borrower has faith, confidence, and trust in the bank, (b) the borrower is in an unequal position and has weakness or lack of knowledge, and (c) the bank exercises dominion, control, or influence over the borrower's business affairs.

<u>Cases</u>[1]

<u>EXCESSIVE CONTROL</u>

Melamed v. Lake County National Bank, 727 F.2d 1399 (6th Cir. 1984). The bank required the president of the company to take a 50% salary reduction, replace the accountant with one the bank had chosen and required the bank's approval for all payments to be made by the company. The president testified that the bank refused to tell him how much money was available and refused to make payments to the company's customers. The bank further issued a memorandum of a course of conduct to "help salvage whatever possible" from the company's financial situation.

In this case, the court held there was sufficient evidence to permit a claim of tortious interference to the jury.

Capital Bank v. MVB, Inc., 644 So.2d 515 (Fla. Dist. Ct. App. 1994). The court held that special circumstances can impose fiduciary duties on a bank including when the bank "exercises extensive control." 644 So.2d at 519 (citing *Tokarz v. Frontier Fed. Sav. & Loan Ass'n*, 33 Wash.App. 456, 462 (1982)). In this case, the bank pressured the borrower into a series of transactions with a company that it knew was in financial trouble while it reassured the borrower that it was good for both the borrower and the bank. The court found that the bank exceeded its role of a lender by advising the borrower to expand his business and acquire the assets of the failing company, and orchestrating and finalizing that transaction. The final nail in the bank's coffin was the fact that the bank received an economic benefit from the transaction because it relieved the bank of a loss from the failing company's non-performing loan. Therefore, the court held that the bank breached its fiduciary duty (created by exercising excessive control and creating trust with the borrower) by taking unfair advantage and not acting in the best interest of the borrower.

Citibank, N.A. v. Data Lease Financial Corp., 828 F.2d 686 (11th Cir. 1987). In some cases, if the bank exerts excessive control, the court may find that an agency relationship is created between the bank and the borrower. In *Data Lease Financial Corp.*, Data Lease borrowed $6.2 million and offered 870,000 shares of capital stock of Miami National Bank as collateral to secure the loan. After Data Lease defaulted, the bank placed individuals on the Miami National board of directors; these individuals subsequently interfered with Data Lease's rights in the pledged stock and misused the Miami National Bank, causing it to deteriorate in value. The 11th Circuit reversed the lower court's grant of summary judgment in favor of the bank.

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[1] Thanks to Mee Soon Langhor, mlangohr@shulmanrogers.com | T 301.945.9272 for assisting with researching and gathering the cases.

Gavin v. Sovereign Bank, No. 06-12314-DPW, 2008 WL 2622839, at 5 (D. Mass. June 30, 2008). The bank insisted that the borrower hire a specific individual, who was the consultant of a competing company, to oversee the accounting department and also have the final approval to hire the borrower's new comptroller. The bank further required the borrower to continue the consultant's employment to supervise and train the new comptroller. The bank also met regularly with the consultant without the borrower to discuss the borrower's financial condition.

However, the court refused to find the bank liable because, while their directives "were perhaps ill-advised, they do not constitute 'absolute, participatory, total control' of [borrower's] operations."

GOOD FAITH AND FAIR DEALING

In *State ex rel. Cordray v. Estate of Roberts*, 188 Ohio App.3d 306 (2010), upon the borrower's default, the bank took control of the property and sold some of the items, but rejected an offer of $100,000 for the building and contents. The bank was aware of the building's deteriorating condition, including that lack of heat would cause pipes to burst and the existence of a hole in the roof from the bank removing and selling a sprayer. The bank took no action to protect the building which became contaminated with black mold. The bank also failed to dispose of chemical drums properly, causing an investigation and charges by the Ohio EPA. Based on the evidence, the court held there was sufficient evidence that the bank breached its duty of good faith and fair dealing and that the bank exercised sufficient control over the property so that the claim of whether the bank was liable for property and environmental damages should go before a jury.

High v. McLean Financial Corp., 659 F.Supp. 1561 (D.D.C. 1987). The court refused to hold that "a fiduciary duty can *never* exist between a lender and a loan applicant." In this case, the borrower applied for a loan with the bank and then alleged that the bank attempted to place the borrower's loan with another lender. The court held that if the bank acted as a broker between the borrower and the second lender, then the bank owed the borrower a duty of good faith and fair dealing.

Central States Stamping Co. v. Terminal Equipment Co., 727 F.2d 1405 (6th Cir. 1984). Sometimes offering advice can create and impose fiduciary duties. In this case, Central States entered into a purchase agreement for Terminal to manufacture equipment for $200,000. Prior to entering into the agreement, Central States inquired about Terminal's financial condition with Lake County National Bank, where Terminal had its loans and the Bank had a supervisory role over Terminal's day-to-day operations. The bank misled Central States by stating that Terminal has been maintaining its commitments to the bank and was trustworthy. In reality, Terminal was in default on two loans with the bank and the bank was aware that Terminal's financial position was shaky. Relying on the bank's assurances, Central States entered into the purchase agreement with Terminal and after making two payments ($50,000), Terminal was adjudged bankrupt. The

court found that when the bank decided to offer advice to Central States, the bank created a duty to disclose information in its possession which would be reasonably considered material to Central States' business decision.

MATERIAL ADVERSE CHANGE

The party invoking the MAC clause has the burden to prove that a material adverse change occurred. *Capitol Justice LLC v. Wachovia Bank, N.A.*, 706 F.Supp.2d 23 (D.D.C. 2009).

Greenwood Place v. Huntington National Bank, 2011 U.S. Dist. LEXIS 78736 (S.D. Ind. July 19, 2011). The court held that whether a change in circumstance constituted a MAC was a question of fact for a jury because the loan documents did not define "any material adverse change." Thus, the court denied the bank's motion for summary judgment.

BANK OFFICER AUTHORITY TO BIND A LENDER

Every bank has lending policies and procedures, part of which identify and define a commercial lending officer's authority to make loans and to extend credit. That is known as actual authority and is based upon parameters that have been memorialized and approved by the bank's management and board of directors. Actual authority defines the extent to which a commercial lending officer is authorized to bind the bank.

However, even in the absence of actual authority, a commercial lending officer's actions might still bind a bank under the doctrines of apparent authority, implied authority, agency by estoppel, or ratification.

Agri Export Cooperative v. Universal Savings Association, 767 F. Supp. 824, 829 (S.D. Tex. 1991) (elementary that bank is bound by acts of its officers while acting within the scope of their authority, either actual or apparent).

In re Canal Refining Co., 2008 WL 5157458, at * 3 (Bankr. W.D. La. June 13, 2008) (corporate officers' actions bind corporation in same way that acts of any agent would bind corporation through actual authority, apparent authority or ratification).

Courts have held that a bank officer's unauthorized actions can bind a bank if third parties have been led to believe that such bank officer had authority to do so. Agency by estoppel and ratification also require that the third party's reliance on such actions be reasonable.

Actual Authority

One way to create an agency relationship is for the principal to confer actual authority on the agent. *Citizens v. Maryland Indus.,* 338 Md. 448, 459, 659 A.2d 313, 318 (1995).

Actual "authority to do an act can be created by written or spoken words or other conduct of the principal which, reasonably interpreted, causes the agent to believe that the principal desires him so to act on the principal's account."

Three Minnows, LLC v. Cream, LLC, 2013 WL 1453246, at *4 (Iowa App. April 10, 2013) (actual authority exists if principal has either expressly or by implication granted agent authority to act on principal's behalf).

Apparent Authority

Under the doctrine of apparent authority, a principal will be bound by a person purporting to act for him only where the principal's words or conduct cause the third party to believe that the principal consents or has authorized the agent's conduct. *Iceland Telecom, Ltd. v. Information Systems and Networks Corp.,* 268 F. Supp.2d 585, 592 (D. Md. 2003).

Sarkes Tarzian, Inc. v. U.S. Trust Company of Florida Savings Bank, 397 F.3d 577, 583 (7th Cir. 2005) (apparent authority is created by principal's words or conduct communicated to third party that give rise to appearance and belief that agent possesses authority to enter into transaction).

Implied Authority

Some courts have recognized that an agent with implied authority may bind its principals. For example, "the responsibility of the principal to third persons is not confined to cases where the contract has been actually made under express or implied authority. It extends further and binds the principal in all cases where the agent is acting within the scope of his usual employment, or is held out to the public, or to the other party, as having competent authority, although, in fact, he or she has, in the particular instance, exceeded or violated his or her authority. *Wailes & Edwards, Inc. v. Bach,* 265 Md. 274, 277-78 (1972).

Agency by Estoppel

The Maryland Court of Special Appeals has held that: "Like apparent authority, an agency by estoppel can arise only where the principal, through words or conduct, represents that the agent has authority to act and the third party *reasonably* relies on those representations" (emphasis in the original). *The Johns Hopkins University v. Ritter,* 114 Md. App. 77, 689 A.2d 91, 96 (1997).

An agency by estoppel can arise only where the principal, through words or conduct, represents that the agent has authority to act and the third party reasonably relies on those representations.

Ratification

Ratification occurs when a principal later adopts an agent's unauthorized act, giving it the same effect as if it had originally been authorized. *Wood v. Walter,* 855 F. Supp. 2d 494, 503 (D. Md. 2012).

When an agent acts with actual authority, a bank is aware of the scope of her actions. Banks should be cautious about actions taken without actual authority which could bind a bank. If an

agent's actions can be construed as being taken with the bank's approval or the institution has manifested some indication that such action was authorized, a bank could find itself liable for such agent's actions. Also, if a bank ratifies actions, even if unauthorized, the bank will be held responsible. Upon discovery of unauthorized actions, it is imperative that a bank disavow any authority to eliminate any ratification argument.

SPOUSAL GUARANTEES AND ECOA

The Equal Credit Opportunity Act ("ECOA") is intended to protect credit applicants against discrimination based upon marital status. Some guarantors have sought to avoid liability under their guaranty by asserting a violation of the ECOA. In 1986, the Federal Reserve Board revised these regulations and, in administering ECOA, issued Regulation B, which defined an applicant to include guarantor. Specifically, Regulation B provides that:

> Except as provided in this paragraph, a creditor shall not require the signature of an applicant's spouse or other person, other than a joint applicant, on any credit instrument if the applicant qualifies under the creditor's standards of creditworthiness for the amount and terms of the credit requested.

Since its promulgation, courts have differed on the propriety of Regulation B, and its inclusion of a guarantor in the term "applicant."

Circuits that Defer to Regulation B

RL BB Acquisition, LLC v. Bridgemill Commons Development Group, 754 F.3d 380 (6th Cir. 2014) (finding that at least one meaning of "applicant" could include guarantors, Sixth Circuit concluded that the Federal Reserve's interpretation was entitled to defense and refused to rule in wife guarantor's favor).

Silverman v. Eastrich Multiple Inv'r Fund, L.P., 51 F.3d 28 (3d Cir. 1995) (wife guarantor appealed the dismissal of her complaint claiming violations of ECOA. Without reaching a conclusion on the merits, the Third Circuit adopted the application of Regulation B and held that if the plaintiff wife was required to sign a spousal guarantee solely for the purpose of facilitating a loan for her spouse and his business, without any inquiry by the lender into her creditworthiness, the guarantee could not be enforced against her by the lender).

Ballard v. Bank of Am. N.A., 734 F.3d 308 (4th Cir. 2013) (business owner's wife was required to sign a guarantee for loans her husband sought to obtain for his business and the Fourth Circuit agreed that ECOA regulations prohibited lenders from requiring a spouse-guarantee when the applicant individually qualified for the requested credit. The court clarified, however, that "not every signature required of a borrower's spouse . . . constitutes credit discrimination under the ECOA).

Anderson v. United Fin. Co., 666 F.2d 1277 (9th Cir. 1982) (Ninth Circuit held that a lender discriminated against a husband in violation of the ECOA by requiring him to sign the loan

documents when his wife, the loan applicant, qualified individually under the lender's standards of creditworthiness).

<u>Circuits that Do Not View Spousal Guarantors as Credit Applicants</u>

Moran Foods, Inc. v. Mid-Atl. Mkt. Dev. Co., LLC, 476 F.3d 436 (7th Cir. 2007) (Seventh Circuit held that the requirement of a guaranty by the franchise owner's spouse was not discrimination on the basis of marital status).

Hawkins v. Community Bank of Raymore, 761 F.3d 937, 940 (8th Cir. 2014) (Eighth Circuit found no basis for the Regulation B application because the statute itself is clear that it applies only to applicants so wife guarantors were not applicants and therefore not protected by the statute).

In upholding *Hawkins*, the Supreme Court issued no written opinion but merely a one-line decision. (*Hawkins v. Cmty. Bank of Raymore*, 136 S. Ct. 1072 (2016) ("The judgment is affirmed by an equally divided Court."). As a result of the tied vote, the Supreme Court's decision in *Hawkins* applies only to the Eighth Circuit states (Missouri, Arkansas, Nebraska, Iowa, Minnesota, South Dakota and North Dakota). Unfortunately, this leaves significant uncertainty for lenders that are located outside of these states, or even to lenders located in both the Eighth Circuit and other circuits.

Although the Supreme Court affirmed the Eighth Circuit's position in *Hawkins,* it did so with only eight justices on the bench. The Supreme Court's decision did not change the law in any of the circuits that follow the Federal Reserve's interpretation of "applicant"—as of now, that includes the Third, Fourth, Sixth, and Ninth Circuits. While the Seventh and Eight Circuits have affirmatively decided not to adhere to the definition of "applicant" in Regulation B, the outcome remains unclear in the First, Second, Fifth, Tenth, and Eleventh Circuits. Accordingly, these courts may still apply ECOA to prohibit a commercial lender from requesting a guaranty solely because a prospective guarantor is married to the borrower.