# Lender Liability Issues

# in

# Commercial Real Estate Loan Workouts

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Part I

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# OUTLINE OF LENDER LIABILITY ISSUES IN COMMERCIAL REAL ESTATE LOAN WORKOUTS

Prepared by:
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## I. ANALYSIS OF WORKOUT AND LITIGATION RISKS

### A. **Complete a Review of the Loan Documents**

- Confirm possession of all original documents, including the note, any letters of credit and any stock/member/partner certificates together with stock/limited liability company/partner power executed in blank
- Confirm perfection of all security interests
- Confirm legal description
- Confirm the validity and completeness of all documentation, including usury
- Review choice of law and forum selection provisions
- Review provisions relating to defaults and notice and cure periods
- Review guarantees – what obligations are guaranteed and in what amounts
- Determine if notice and/or the consent of co-lenders, participants or senior lender (e.g. the mortgage lender in the case of a mezzanine loan) is required, if applicable

### B. **Pre-Negotiation Agreement**

- If modification or restructuring is be considered, require a borrower and guarantors to enter into pre-negotiation agreement

### C. **Value the Collateral Securing the Loan**

- Order updated appraisal of the property
- Order title bring down
- Order lien searches
- Order updated Phase I Environmental Report, if applicable
- Request most recent financial reports from the borrower, if outstanding

### D. **Identify Goals, Restrictions and Concerns**

- Is the lender prepared to own and operate the asset?

- Does lender have the corporate power and authority to operate the asset?
- Identify potentially acceptable outcomes (e.g. (x) restructuring or loan modification, (y) deed in lieu, or (z) foreclosure)
- Is the lender qualified to transact business in all appropriate jurisdictions?

E. **Assess Risks of Lender Liability**

1. **Breach of contract**.

(a) Breach of written covenants. Lenders may be subject to liability for a breach of the express terms of a contract.

(b) Breach of oral covenants. Courts have found lenders liable for oral agreements despite lender assertions that the governing loan documents or applicable law require agreements to be in writing (the "Parol Evidence Rule"). Exceptions to the Parol Evidence Rule include:

- Partial performance – many courts will enforce an oral agreement when it is coupled with partial performance.
- Fraud – the parol evidence rule does not bar a claim of fraud.
- Mutual Mistake – the parol evidence rule does not apply to a situation where mutual mistake is alleged.

(c) Two illustrative cases:

(i) *NationsBank of Tennessee v JDRC Corporation, et al.* 1997 WL 290188 (1997). The Court of Appeals of Tennessee ruled that an internal commercial loan memorandum was admissible despite the Parol Evidence Rule, and that such document was sufficient to satisfy legal requirement to prove an oral modification to written loan documents.

(ii) *Royal Mortgage Corp. v FDIC.* 20 F. Supp.664 (1998). Permitting, under New York law, evidence of subsequent oral modification of a written agreement even though the agreement itself prohibited modifications other than in writing.

(d) Protection. Use a pre-negotiation Agreement to prevent inadvertent modification. In addition, memorialize in correspondence (including e-mail), conversations with Borrower that may be susceptible to misunderstanding in order to clearly state that there is no agreement where is none is intended.

2. **Duty of Good Faith and Fair Dealing**. Under various circumstances, lenders have been held liable for a breach of an implied covenant of good faith and fair dealing even though the lender did not violate any express term of the

contract. While contracts governed by the Uniform Commercial Code ("UCC") are generally subject to an obligation of good faith and fair dealing. (§1-304), the laws of the various states differ upon the existence and extent of the covenant with respect to mortgage loan documents. Sometimes courts have implied the covenant with respect to mortgage loan documents based on the inclusion in the documents then before the court of UCC remedies, other courts have implied the covenant by analogy to UCC provisions, and others as a common law doctrine. Even states that technically do not generally imply the covenant to mortgage loans may imply an obligation of good faith where there is an relationship of particular trust or other special relationship.

Where the covenant is implied, it is not breached merely by the enforcement by one party of its contractual rights that may work a hardship on a counterparty. The covenant is breached where a party acts in bad faith to deprive a party of the fruits of its labor already substantially earned or by unfairly leveraging the contract's terms. Blue Hill Office Park LLC v. J.P. Morgan Chase Bank, 477 F. Supp.2d 366 (D. Mass. 2007).

Illustrative of the type of case where a court has found a breach of the implied covenant of good faith and fair dealing is *Ssangyong (U.S.A.), Inc. v Innovation Group, Inc., et al.*, 2000 WL 1339206 (S.D. Iowa), where the court ruled that the lender's commercially unreasonable delay in processing letters of credit was a breach of the covenant of good faith and fair dealing. The plaintiff-borrower and defendant-lender entered into a financing arrangement. Two years into the relationship, a new Vice President of the defendant with responsibility for approving the plaintiff's requests for letters of credit. The new Vice President, uncomfortable with the financing arrangement, intentionally began slowing the approval process. The Vice President's actions caused the plaintiff to loose several customers. The court found (x) that the slow down in the approval process was commercially unreasonable and (y) no evidence existed to show that the slow down was tied to any bona fide purpose. The court held that the lender's actions amounted to a breach of the covenant of good faith and fair dealing. See *Arnold v National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987) (a duty of good faith is not imposed in every contract but only in a special relationship marked by shared rust or an imbalance of bargaining power), and *English v Fischer*, 660 S.W.2d 521, 522 (the relationship between a lender and borrower or mortgagor and mortgagee does not involve a duty of good faith and fair dealing), for cases where no implied covenant was found to exist.

3. **<u>Breach of Duty to Act Reasonably</u>**. A corollary to the duty of good faith is the duty to act in a commercially reasonable manner. The issue comes up often in the context of borrower requests for lender consent and in the context of guarantors claiming harm by unreasonable lender conduct. In this context, the language of the applicable loan documents is very important. Guaranties containing proper waivers of guarantor defense based upon lender dealings with borrower and loan document consent provisions within lender's "sole discretion,"

will generally be respected. This is does not hold, however, for obligations of lender where the applicable law, particularly the UCC imposes a requirement of reasonableness (e.g., the disposition of collateral). Also, where the loan document is silent, some but not all jurisdictions will impose a requirement of commercial reasonableness. See for example:

• *Silver v Rochester Savings Bank*, 73 A.D.2d 81 (1980) where the court held that, because the loan documents contained a clause that consent shall not be unreasonably withheld, in a mortgage containing a form of due-on-sale provision, it was unreasonable for the lending institution to withhold its consent unless the new buyer agreed to pay a higher rate of interest on the mortgage to be assumed. The court when on to state though that where mortgages did not contain a reasonableness qualifier, it would not imply one.

4. **Fraud**.

(a) Fraudulent inducement in connection with the making of a loan

(b) Fraudulent conduct committed in the course of the workout process

5. **Duress**. Economic or business coercion, typically based on acts or threats made by the lender, with no legal right or basis, which causes a party to act against its free will and take action for which it is not otherwise obligated.

6. **Breach of Fiduciary Duty**. Fiduciary relationships may be found where the lender exercises control over the borrower, where the borrower has trust and confidence in the lender and where the borrower is in a position of dependence, inequality or lack of knowledge. If a lender-borrower relationship is kept at arm's length, the relationship is not fiduciary. For example, in *Scott v Dime Savings Bank*, 101 F3d 107 (1996), Borrower applied for a loan from the bank. The bank persuaded the borrower to borrow 20x more than he had originally requested and to open a trading account with the bank using the loan proceeds. The trading account was eventually wiped out and the borrower sued the bank for breach of fiduciary duty. The court found in favor of the borrower, finding a fiduciary relationship existed because the bank failed to keep its banking and investment advice separate.

7. **Interference and Control**. A Lender may be exposed to liability based upon the following theories:

(a) Control. A lender's pervasive control of the borrower (outside of the rights expressly granted to lender under the loan documents) or excessive involvement in the conduct of the borrower's business, which results in damage to the borrower or a third party.

(i) *State Nat. Bank v Farah Mfg. Co., Inc.* 678 SW2d 661 (1984). In Farah, the court held that the lender compelled the election of directors and officers whose business judgment, experience, and

divided loyalties resulted in injury to the company and further, that the lender's packing of the board with its own nominees, its appointment of its own person as a consultant and later CEO, and their sale of the company's assets, constituted an unlawful interference with the company's right to lawful management and proper corporate governance.

*Credit Managers Association of Southern California v The Superior Court of Los Angeles County.* 51 Cal. App.3d 352. In this case, the lender, upon discovering the financial difficulties of the borrower, forced the debtor to hire a business consultant with the threat that the failure to do so would result in foreclosure. The business consultant was an agent of the lender and served as a consultant to represent the lender in the management of the borrower's business. In a short period of time, the policies and procedures implemented by the business consultant reduced the borrower from a business entity with a fair market value of $1 million to a state of insolvency. The court held the lender liable to the borrower for the actions of the business consultant.

(b) <u>Factors used in determining whether undue control has been exerted include</u>:

- How extensively did the lender interpose itself in the borrower's business?
- Did the borrower consent to the lender's acts?
- Was there a need for drastic or immediate action on the part of the lender?
- Did the lender's acts benefit only the lender at the expense of the borrower and the borrower's creditors?
- Did the borrower in any way benefit from the lender's acts?

(c) <u>Examples of excess control</u>:

- The lender insists on obtaining control over the borrower's disbursements and decides who to pay in its discretion.
- The lender requires that the borrower turn over the proceeds from the sales of its product (or rents collected) to the lender, so that the lender can pay the borrower's creditor.
- The lender insists on controlling the borrower's day-to-day operations, such as demanding that the borrower lease its property to certain tenants at certain prices.

• The lender imposes strict or oppressive policies on the borrower, especially policies relating to personnel.

(d) Exerting excess control in the context of the Doctrine of Equitable Subordination. "Equitable subordination" is a bankruptcy concept which serves to subordinate the claims of a creditor to the claims of others when it is determined that such creditor engaged in inequitable conduct which has injured the other creditors. Merely enforcing contractual lender remedies should not result in equitable subordination. The cases generally distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation or the exercise of such total control over the debtor as to have essentially replaced its decision making capacity with that of the lender (i.e., to have made borrower a mere instrumentality of the lender). Illustrative cases included:

• *In re American Lumber Co.,* 5 B.R. 470, where the court subordinated the lender's liens based upon its determination that the defendant-bank (x) "controlled" the debtor through its right to a controlling interest in the debtor's stock, (y) had forced the debtor to convey security interests in its remaining unencumbered assets to the bank after the borrower defaulted on an existing debt, and (z) had immediately thereafter, foreclosed on the borrower's accounts receivable, terminated the borrower's employees, hired its own skeleton crew to conduct liquidation, and selectively honored the debtor's payables to improve its own position. The bank exercised control over all aspects of the debtor's finances and operations including: payments of payables and wages, collection and use of accounts receivable and contract rights, purchase and use of supplies and materials, inventory sales, a lumber yard, the salaries of principals, the employment of employees, and the receipt of payments for sales and accounts receivable.

*Clark Pipe and Supply Co., Inc., Debtor v. Associates Commercial Corporation, Creditor.* 893 F.2d 693 (1990), where the found the doctrine of equitable subordination was not warranted because the Creditor's control over the Debtor (specifically, its control over the finances of the Debtor) was expressly permitted by the loan documents and was not severe enough to evoke such a remedy.

• *In re Teltronics Services, Inc. 29 B.R. 139.* Close watch over a Debtor's affairs does not, by itself, amount to such control as would justify equitable subordination.

(e) Interference with contractual affairs or business relationships. A lender can be held liable for its wrongful intrusion into the business affairs of a borrower. The elements of such a claim include:

- existence of a valid contract

- the defendant's knowledge of the contract

- an intent to interfere with the contract

- damage caused by such interference

(f) Interference with corporate governance. When a lender seeks to usurp the control of a corporation's board of directors or management, and such usurpation works to the detriment of the corporation, the lender can be held liable.

8. **Defamation**. Any communication by a creditor to a third party which is later judged to be false may provide grounds for a tort claim of libel or slander. For example, in *Giant Screen Sports v Canadian Imperial Bank of Commerce*. 553 F.3d 527 (2009), the borrower had pledged and assigned to lender certain payment rights owed to it by plaintiff as collateral security for a credit facility from the defendant lender. The defendant lender made statements regarding the purported failure of the plaintiff to pay its obligations to the borrower to an insurer of certain borrower obligations under the credit agreement. The United States Court of Appeals for the Seventh Circuit held under Illinois law that the lender's statements regarding the plaintiff's alleged default were defamatory per se.

9. **Breach of Confidentiality**. A lender may be held liable for disclosing trade secrets or other confidential information provided to it by a borrower.

F. **Mortgagee in Possession.** When a lender exercises such control over a property as to effectively be considered in possession, it basically subjects itself to the obligations of the owner and may incur liability to trade creditors and others, as well as to borrower for losses on the lender's watch. In order to avoid the potential liability of a "mortgagee in possession," a lender may petition the appropriate court for the appointment of a receiver to manage the property until the foreclosure sale. The standards for obtaining a receiver vary somewhat by state. Generally, a provisions entitling lender to the appointment of a receiver upon an event of default will help the lender obtain the same. Absent such a provision, many states require a showing of waste or imminent harm.

G. **Risks Associated with Exercising certain Contract Rights**

1. **Replacing the Property Manager**. Standard structured commercial real estate loan documents permit the lender to replace the property manager upon an event of default and certain other instances. Absent special circumstances (e.g., verbal commitments from lender regarding the manager), replacing the property manager is the exercise of a contract right and when done in accordance with the loan documents should not subject the lender to liability. However, replacing the property manager, particularly with one that is an affiliate of the lender, would be

an indicia of lender's taking control over the property, perhaps to an extent that causes lender to be a mortgagee in possession or otherwise exposes the lender to liability and would be a factor in determining whether or not the borrower had become a mere instrumentality of the Lender for purposes of determining equitable subordination or other lender liability.

2. **Exercising Cash Management**. Another standard structured loan remedy is the right to seize control of the cash following an event of default or occurrence of a covenant breach. This remedy is of particular importance to a lender who suspects that the property manager is misappropriating funds or applying funds other than in accordance with the terms of the loan documents. Exercising cash management in accordance with the terms of the loan documents and applying objective standards set forth in the loan documents should not lead to lender liability. Control of the cash is a factor, however, in determining whether or not lender has stepped over the line and is exercising too much control over the borrower. While there is no bright line rule, the exercise by lender of discretion over the use of the cash (e.g., lender determines which vendors to pay and which not to pay) as opposed to simply approving or disapproving borrower requests in accordance with objective standards set forth in the loan agreement is a material bad fact in determining whether lender has exercised such control over the borrower as warrants the imposition of liability, the characterization of it as a mortgagee in possession or the equitable subordination of its lien.

In *Clark Pipe v Associates Commercial Corporation*, discussed above, the court found that although lender admitted it controlled cash in such a way so as to put itself in the best position possible before bankruptcy, the application of the doctrine of equitable subordination could not be justified because the lender was acting according to the express terms of the loan documents which were negotiated at arm's length and which contained customary terms for transactions of this type. In rendering its decision, the court relied on the fact that, while the lender was controlling the flow of cash to the borrower, the lender did not expressly dictate which bills the borrower was to pay. The same court that handed down the Clark Pipe decision came to a different conclusion in In re American Lumber Co., discussed above. In that case, the court cited the defendant-bank's control over all aspects of the debtor's finances as a key element in its determination that the doctrine of equitable subordination was warranted.

In addition to being exposed to liability or having its lien subordinated, the exercise of cash management in certain states can be detrimental to a lender's right to pursue all other available remedies. In some states (i.e. California), seizing control of the cash and then applying it to pay down the loan can trigger a one-form-of-action rule which can prevent the lender from, inter alia, holding a foreclosure sale or pursuing a deficiency judgment. It is important that applicable state laws be reviewed prior to exercising cash management to ensure that proper state procedures are followed and that all available remedies are being preserved.

H. **Minimize Risks of Lender Liability**

1. **Institute Communication Controls**. Establish a formal line of communication which channels all communications through a designated representative. This will make it easier to measure and monitor potential risk and exposure.

2. **Be Cautious of Oral and Written Communications**. Today's communications may become tomorrow's evidence. Communications should focus on facts and data which are either offered by the debtor or verifiable by the creditor. Expressions of opinion or speculation should be reserved for internal, private conversations which are not documented. Additionally, review borrower communications carefully for attempts to "set-up" the lender, and respond appropriately.

3. Pre-Negotiation Agreement. As mentioned above, insist on a pre-negotiation agreement with borrower and guarantors, if restructuring conversations are to be had; and memorialize substantive calls with borrower to clearly spell out necessary conditions or reservations to proposed agreements.

4. **Be Cautious of Expressions of Intent**. Desperate debtors are quick to construe language as a promise or commitment. It is prudent to have counsel circulate notes following a meeting or lengthy negotiation between the parties. The purpose of the notes is not so much to summarize the meeting but rather to emphasize the non-biding and preliminary nature of any discussions.

5. **Involve Counsel Early in the Process**. Counsel can provide valuable controls in the process. Additionally, the attorney/client privilege and, for counsel, the work product doctrine may be used to protect sensitive and frank communications from being opened up to discovery at a later date.

6. **Laws Vary By State**. While this outline discusses the general principals of lender liability, the law varies state by state. In any particular case, the law of the applicable state or states needs to be researched and a local counsel will need to be involved.

## II. MULTI-LENDER TRANSACTIONS

A. **Allocation of Control Between Lenders**. Typically in multi-lender transactions, one lender takes the lead in servicing the loan and dealing with the borrower. The co-lender, participation or intercreditor agreement (the "Intercreditor Agreement") in turn governs the relationship between the lenders. Particularly, the Intercreditor Agreement sets forth the rights and duties of the lenders in a work-out situation. Generally, the Intercreditor Agreement governs the relationship among the lenders, but it is important to note that where the relationship is not covered by contract, different forms of multi-lender relationships (e.g., participants versus co-lenders) are treated differently by the courts (e.g., a co-lender holding a separate note has its own claim against the borrower in a bankruptcy – again subject to the terms of the Intercreditor Agreement).

B. **Lender Liability Claims Amongst Lenders**.

1. **Breach of Contract**. Causes of action involving two lenders often involve a breach of contract claim. If a lender fails to perform an act specifically required by the intercreditor agreement, such lender may be liable to the co-lender for its nonperformance. These are contract cases to which standard judicial rules for the construction of contracts apply. Absent fraud or other events outside the four corners of the contract, the courts will generally enforce the terms of the agreement based on the original intent of the parties as discerned by the court.

(a) *Continental Bank N.A. v Old Kent Bank and Trust Company*. 1994 WL 710301 (N.D. Ill.). Plaintiff sued defendant claiming defendant's release of collateral following the borrower's event of default was a breach of the terms of the participation agreement. The participation agreement stated that the lender could not, without the consent of the participant, amend, modify or waive any provision of the loan agreement or other loan documents. The court ruled for the defendant, finding that the defendant had the right under the governing documents to transfer, deposit or surrender control of any collateral upon the occurrence of an event of default and thus, the release of the collateral was not an amendment, modification or waiver of any term of the loan documents.

(b) *New Bank of New England, N.A. v The Toronto-Dominion Bank, et al.* 768 F. Supp. 1017 (1991). Lender holding minority interest in a syndicated loan brought action to compel majority lenders to exercise remedies of acceleration and foreclosure. Under the terms of the governing loan agreement, upon a borrower's default, the vote of a majority of the lenders was required to exercise remedies of acceleration and foreclosure. The court held that the minority lender could not compel the majority lenders to accelerate and foreclose and further, provisions in the governing loan agreement against implied covenants, duties or obligations barred the minority lender's claim that majority lender had an implied obligation of good faith to accelerate and foreclose. However, the court held the minority lender was able to block a modification of the loan documents because the loan documents could not be materially modified "without the written consent of all the lenders."

2. **Breach of the Required Standard of Care**. Most Intercreditor Agreements expressly disclaim the lead lender's liability other than for gross negligence and willful misconduct. This language is subject to some interpretation by the courts and some lenders may be held to a higher standard of care, particularly due to the level of sophistication of the involved parties. Courts, however, are reluctant to find the existence of a fiduciary duty between the lead lender and other lenders and even if they do, courts recognize that the relationship can be modified or qualified by the express terms of the contract.

(a) *American Bank & Trust of Coushatta, et al. v FDIC*. 49 F. 3d 1064 (1995). Language in the loan participation agreements that the lead bank would not be liable to other banks so long as it acted in "good faith" did

not permit banks to recover from the FDIC (in its capacity as a receiver for the lead bank) for it's negligence or even gross negligence and FDIC's actions did not exhibit "intentional maliciousness" required for other banks to recover under the participation agreements.

(b) *Banque Arabe Et Internationale D'Investissement v Maryland National Bank.* 819 F. supp. 1282. (1993). Court held that in an arm's length transaction between two large financial institutions, a fiduciary duty does not exist unless it is expressly created by the terms of the agreement.

3. **Failure to Disclose and Misrepresentation**. Typically, the right to receive information or to review periodic reports is outlined in the Intercreditor Agreement. Beyond contractually mandated disclosures, the lead lender has an obligation arising out of the tort law concept of misrepresentation to reveal accurate information. Under general tort law, misrepresentation occurs if one party knowingly or recklessly makes a material misrepresentation of material fact on which the other party relies. In some instances, the party making the misrepresentation has to know or have reason to know that the other party is relying upon it.

*Banque Arabe Et Internationale D'Investissement v Maryland National Bank.* 819 F. supp. 1282. (1993). This case involved a loan to a borrower converting apartments into condominiums in New York City. Plaintiff alleged that defendant defrauded it because defendant knew that plaintiff was relying upon information provided by lead lender and that the lead lender had intentionally failed to disclose material (x) certain construction delays, (y) errors in information provided by defendant to plaintiff, and (z) objections to the borrower's condominium offering materials raised by the applicable New York State department. Despite being aware the plaintiff was relying on the information it provided, and that certain information it failed to disclose would be material to the plaintiff, the defendant failed to disclose such information. The court found that because the defendant had "superior knowledge" and further, the information was not "readily available" to the plaintiff, the defendant had a duty to disclose the information to the plaintiff. The court found that the superior knowledge of the plaintiff overcame language in the participation agreement that the plaintiff conducted an independent credit analysis and was basing its decision to purchase the participation interest on its own analysis without reliance on the defendant.

*Banco Totta e Acores v Fleet National Bank.* 768 F. Supp. 943 (1991). Participant sought rescission of participation in a loan on the basis that the lead bank had a duty to disclose that the debtor was under investigation for possible Medicaid fraud. The court ruled against the participant on the basis that the participation agreement contained language that the participation was purchased solely on the participant's independent credit evaluation.

4. **Breach of Implied Covenant of Good Faith**. Agreements between lenders are also contracts as to which the implied covenant of good faith and fair dealing may apply under the same theories as with respect to loan documents between a borrower and a lender (UCC either directly or by analogy or common law doctrine). For example, in *Ranier v Mount Sterling National Bank*, 812 S.W.2d 154 (1991), a second mortgage holder sued the first for breach of the duty of good faith and fair dealing. The lenders were parties to a subordination agreement. Subsequent to its execution, defendant lent an additional $75K to the debtor without notice to the subordinate lender. The debtor defaulted on the loans and the senior lender foreclosed. The senior lender applied mortgage payments it received first to pay down the new money it had advanced. The court found that the defendant had breached its implied covenant of good faith and fair dealing when it failed to give notice to the plaintiff of its subsequent loan to the debtor and when it unilaterally applied the mortgage payments it received from the debtor first to the unsecured portion of the new promissory note.

## III. CONCLUSION

A. **Current Trends.** Following the 1984 seminal case of Farah (discussed above), courts saw a wave of lender liability cases. Borrowers were continually coming up with novel theories on which to sue lenders. Many of these cases, while successful at the trial level, were ultimately overturned at the appellate level. Over the past ten or twelve years, the majority of lender liability cases have been limited to more traditional theories of tort and contract law (e.g., breach of contract and fraud) and borrowers have not generally met with much success. We are monitoring current developments closely and see some cause for concern that courts may become more borrower friendly in the current economic climate. In addition, borrowers may well find new grounds for complaint based on the frustration of the master servicer to special servicer process. We have already seen borrower's have some success in defending foreclosure actions on the basis that the plaintiff could not establish that it was the owner of the note and mortgage. Generally these cases have been limited to the residential context, but there has now been at least one case involving a commercial loan held by MERS.

B. **Summary.** The risk of lender liability is real, but generally managable. Adherence to the loan documents, clear and thoughtful communications with the borrower, proper documentation (e.g., pre-negotiation agreements), and responding appropriately and timely to borrower correspondence can all help to protect against inadvertently incurring liability.

The foregoing outline is a general overview of discussion purposes. It is not intended as legal advice with respect to any fact situation in any particular jurisdiction. Appropriate counsel should be consulted with respect to any specific circumstances.

# OUTLINE OF LENDER LIABILITY ISSUES IN COMMERCIAL REAL ESTATE LOAN WORKOUTS

# Part II

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contract. While contracts governed by the Uniform Commercial Code ("UCC") are generally subject to an obligation of good faith and fair dealing. (§1-304), the laws of the various states differ upon the existence and extent of the covenant with respect to mortgage loan documents.[1] Sometimes courts have implied the covenant with respect to mortgage loan documents based on the inclusion in the documents then before the court of UCC remedies, other courts have implied the covenant by analogy to UCC provisions, and others as a common law doctrine. Even states that technically do not generally imply the covenant to mortgage loans may imply an obligation of good faith where there is an relationship of particular trust or other special relationship.

Where the covenant is implied, it is not breached merely by the enforcement by one party of its contractual rights that may work a hardship on a counterparty.

(a) *Schwanbeck v. Federal-Mogul Corp.*, 578 N.E. 2d 789, 795 (Mass. App. Ct. 1991) stating, "good faith means something less than unremitting efforts to get to "yes" with the players at all times playing their cards face up. Rather the obligation means that preliminary agreement has not been entered into for some ulterior purpose, such as to set up the proposed buyer from the outset as a stalking horse for another buyer, or to satisfy a creditor that steps to transform an asset into cash are actually under way." *Schwanbeck v Federal-Mogul Corporation, et al.* 592 N.E.2d 1289 (Mass. Sup. Ct. 1992) where the court held that the parties never bound themselves contractually to negotiate in good faith, citing the settled principal of contract law that "[a] promise made with an understood intention that it is not to be legally binding, but only expressive of a present intention, is not a contract" (Schwanbeck citing Kazmeskus v Pickup Motor Co., 330 Mass. 490, 493 (1953).

(b) *Blue Hill Office Park LLC v. J.P. Morgan Chase Bank*, 477 F. Supp.2d 366 (D. Mass. 2007) The covenant is breached where a party acts in bad faith to deprive a party of the fruits of its labor already substantially earned or by unfairly leveraging the contract's terms.

(c) *WP 851 Assoc., L.P. v. Wachovia Bank*, 2008 WL 114992 at *8 (E.D. Pa., Jan 10, 2008). Wachovia sent WP 851 a letter of intent ("LOI") outlining the proposed lease terms which was never signed. WP 851 claimed that Wachovia breached the duty to negotiate in good faith, the

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[1] Under the rule, the implication to use "best efforts" is clearly predicated on the lack of an express promise." Perma Research & Development Company v. Singer Company, 308 F. Supp. 743 (1970). The "Duff-Gordon" case decided by Justice Cardozo is later referred to by him in distinguishing between the older "primitive stage of formalism when the precise word was the sovereign talisman, and every slip was fatal" compared to the approach of "realism" which supports the exercise of discretionary judgment by the court to avoid inequitable outcomes. Benjamin N. Cardozo, "The Nature of the Judicial Process." (1921) page 100.

Some jurisdictions impose the implicit obligation in the case of contracts to negotiate in good faith, but only upon determination that a contract exists. Rennick v. O.P.T.I.O.N. Core, Inc., 77 F. 3d 309, 317 (9th Cir. 1996), other jurisdictions have flatly rejected the implication of a general duty of good faith and fair dealing in all contracts. City of Midland v. O'Bryant, 18 S.W. 3d 209, 215 (Tex. 2000).

court found that "[a]lthough the Pennsylvania Supreme Court has not found that a cause of action for breach of a duty to negotiate in good faith exists under Pennsylvania law, the Court of Appeals for the Third Circuit has predicted that the Pennsylvania Supreme Court would find that an agreement to negotiate in good faith would be enforceable if it meets the requisite elements of a contract.".

(d) *Ssangyong (U.S.A.), Inc. v Innovation Group, Inc., et al.*, 2000 WL 1339206 (S.D. Iowa). The court ruled that the lender's commercially unreasonable delay in processing letters of credit was a breach of the covenant of good faith and fair dealing. The plaintiff-borrower and defendant-lender entered into a financing arrangement. A new Vice President of the defendant with responsibility for approving the plaintiff's requests for letters of credit felt uncomfortable with the financing arrangement and intentionally began slowing the approval process. The Vice President's actions caused the plaintiff to loose several customers. The court found (x) that the slow down in the approval process was commercially unreasonable and (y) no evidence existed to show that the slow down was tied to any bona fide purpose. The court held that the lender's actions amounted to a breach of the covenant of good faith and fair dealing.

(e) See *Arnold v National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987) (a duty of good faith is not imposed in every contract but only in a special relationship marked by shared trust or an imbalance of bargaining power), and *English v Fischer*, 660 S.W.2d 521, 522 (the relationship between a lender and borrower or mortgagor and mortgagee does not involve a duty of good faith and fair dealing), for cases where no implied covenant was found to exist. Also see [o]ur courts have not determined whether a cause of action for breach of duty to negotiate in good faith exists in Pennsylvania." *GMH Assocs., Inc. v. Prudential Realty Group*, 752 A.2d 889, 903 (Pa. Super. 2000); see also *Jenkins v. County of Schuylkill*, 658 A.2d 380, 384-385 (Pa. Super. 1995) (addressing appellant's assertion "that a cause of action for breach of good faith negotiations should be cognizable in Pennsylvania," the court declined to determine "whether a cause of action for breach of a duty to negotiate in good faith exists in Pennsylvania*."); Philmar Mid-Atlantic v. York St. Associates*, 566 A.2d 1253, 1255 (Pa. Super. 1989) ("Pennsylvania courts have not considered whether a letter of intent gives rise to an obligation to negotiate in good faith.").[2]

3. **Breach of Duty to Act Reasonably**. A corollary to the duty of good faith is the duty to act in a commercially reasonable manner. The issue comes up often

[2] In fact, even a recent federal court decision on this issue recognized that, "the Pennsylvania Supreme Court has not found that a cause of action for breach of the duty to negotiate in good faith exists under Pennsylvania law." WP 851 Assoc., L.P. v. Wachovia Bank, 2008 WL 114992 at *8 (E.D. Pa., Jan 10, 2008).

in the context of borrower requests for lender consent and in the context of guarantors claiming harm by unreasonable lender conduct. In this context, the language of the applicable loan documents is very important. Guaranties containing proper waivers of guarantor defense based upon lender dealings with borrower and loan document consent provisions within lender's "sole discretion," will generally be respected. This is does not hold, however, for obligations of lender where the applicable law, particularly the UCC imposes a requirement of reasonableness (e.g., the disposition of collateral). Also, where the loan document is silent, some but not all jurisdictions will impose a requirement of commercial reasonableness.

(a) *Silver v Rochester Savings Bank*, 73 A.D.2d 81 (1980) where the court held that, because the loan documents contained a clause that consent shall not be unreasonably withheld, in a mortgage containing a form of due-on-sale provision, it was unreasonable for the lending institution to withhold its consent unless the new buyer agreed to pay a higher rate of interest on the mortgage to be assumed. The court when on to state though that where mortgages did not contain a reasonableness qualifier, it would not imply one.

(b) *Pinnacle Books, Inc. v. Harlequin Enterprises Limited*, 519 F. Supp 1181, 121 (S.D.N.Y 1981), holding that an agreement to negotiate "using best efforts" is unenforceable for indefiniteness unless the agreement elaborates a clear set of guidelines by which the parties' efforts can be measured. The court renounced a prior decision which held that an agreement to negotiate with best efforts was actionable, unlike an agreement to agree.

(c) *Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 613 (1979), "Other cases suggest that under New York law a 'best efforts' clause imposes an obligation to act with good faith in light of one's own capabilities. . . . A summary definition of the best efforts obligation . . . is . . . to wit, performing as well as 'the average prudent comparable' brewer. The net of all this is that the New York law is far from clear and it is unfortunate that a federal court must have to apply it." (references omitted).

4. **Fraud**.

(a) Fraudulent inducement in connection with the making of a loan

(b) Fraudulent conduct committed in the course of the workout process

5. **Duress**. Economic or business coercion, typically based on acts or threats made by the lender, with no legal right or basis, which causes a party to act against its free will and take action for which it is not otherwise obligated.

6. **Breach of Fiduciary Duty**. Fiduciary relationships may be found where the lender exercises control over the borrower, where the borrower has trust and

confidence in the lender and where the borrower is in a position of dependence, inequality or lack of knowledge. If a lender-borrower relationship is kept at arm's length, the relationship is not fiduciary.

(a) *Scott v Dime Savings Bank*, 101 F3d 107 (1996), Borrower applied for a loan from the bank. The bank persuaded the borrower to borrow 20x more than he had originally requested and to open a trading account with the bank using the loan proceeds. The trading account was eventually wiped out and the borrower sued the bank for breach of fiduciary duty. The court found in favor of the borrower, finding a fiduciary relationship existed because the bank failed to keep its banking and investment advice separate.

7. **Interference and Control**. A Lender may be exposed to liability based upon the following theories:

(a) Control. A lender's pervasive control of the borrower (outside of the rights expressly granted to lender under the loan documents) or excessive involvement in the conduct of the borrower's business, which results in damage to the borrower or a third party.

(i) *State Nat. Bank v Farah Mfg. Co., Inc.* 678 SW2d 661 (1984). In Farah, the court held that the lender compelled the election of directors and officers whose business judgment, experience, and divided loyalties resulted in injury to the company and further, that the lender's packing of the board with its own nominees, its appointment of its own person as a consultant and later CEO, and their sale of the company's assets, constituted an unlawful interference with the company's right to lawful management and proper corporate governance.

(ii) *Credit Managers Association of Southern California v The Superior Court of Los Angeles County*. 51 Cal. App.3d 352. In this case, the lender, upon discovering the financial difficulties of the borrower, forced the debtor to hire a business consultant with the threat that the failure to do so would result in foreclosure. The business consultant was an agent of the lender and served as a consultant to represent the lender in the management of the borrower's business. In a short period of time, the policies and procedures implemented by the business consultant reduced the borrower from a business entity with a fair market value of $1 million to a state of insolvency. The court held the lender liable to the borrower for the actions of the business consultant.

(b) Factors used in determining whether undue control has been exerted include:

- How extensively did the lender interpose itself in the borrower's business?
- Did the borrower consent to the lender's acts?
- Was there a need for drastic or immediate action on the part of the lender?
- Did the lender's acts benefit only the lender at the expense of the borrower and the borrower's creditors?
- Did the borrower in any way benefit from the lender's acts?

(c) Examples of excess control:

- The lender insists on obtaining control over the borrower's disbursements and decides whom to pay in its discretion.
- The lender requires that the borrower turn over the proceeds from the sales of its product (or rents collected) to the lender, so that the lender can pay the borrower's creditor.
- The lender insists on controlling the borrower's day-to-day operations, such as demanding that the borrower lease its property to certain tenants at certain prices.
- The lender imposes strict or oppressive policies on the borrower, especially policies relating to personnel.
- Exerting excess control in the context of the Doctrine of Equitable Subordination. "Equitable subordination" is a bankruptcy concept which serves to subordinate the claims of a creditor to the claims of others when it is determined that such creditor engaged in inequitable conduct which has injured the other creditors. Merely enforcing contractual lender remedies should not result in equitable subordination. The cases generally distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation or the exercise of such total control over the debtor as to have essentially replaced its decision making capacity with that of the lender (i.e., to have made borrower a mere instrumentality of the lender). Illustrative cases included:

  (i) *In re American Lumber Co.*, 5 B.R. 470, where the court subordinated the lender's liens based upon its determination that the defendant-bank (x) "controlled" the debtor through its right to a controlling interest in the debtor's stock, (y) had forced the debtor to convey security interests in its remaining unencumbered assets to the bank after the borrower defaulted on an existing debt, and (z) had immediately thereafter, foreclosed on the borrower's accounts receivable, terminated the borrower's employees, hired its own skeleton crew to conduct liquidation, and selectively honored the debtor's payables to improve its own position. The

bank exercised control over all aspects of the debtor's finances and operations including: payments of payables and wages, collection and use of accounts receivable and contract rights, purchase and use of supplies and materials, inventory sales, a lumber yard, the salaries of principals, the employment of employees, and the receipt of payments for sales and accounts receivable.

(ii) *Clark Pipe and Supply Co., Inc., Debtor v. Associates Commercial Corporation, Creditor*. 893 F.2d 693 (1990), where the found the doctrine of equitable subordination was not warranted because the Creditor's control over the Debtor (specifically, its control over the finances of the Debtor) was expressly permitted by the loan documents and was not severe enough to evoke such a remedy.

(iii) *In re Teltronics Services, Inc. 29 B.R. 139*. Close watch over a Debtor's affairs does not, by itself, amount to such control as would justify equitable subordination.

(d) Interference with contractual affairs or business relationships. A lender can be held liable for its wrongful intrusion into the business affairs of a borrower. The elements of such a claim include:

- existence of a valid contract
- the defendant's knowledge of the contract
- an intent to interfere with the contract
- damage caused by such interference

(e) Interference with corporate governance. When a lender seeks to usurp the control of a corporation's board of directors or management, and such usurpation works to the detriment of the corporation, the lender can be held liable.

8. **Defamation**. Any communication by a creditor to a third party which is later judged to be false may provide grounds for a tort claim of libel or slander.

*Giant Screen Sports v Canadian Imperial Bank of Commerce*. 553 F.3d 527 (2009), the borrower had pledged and assigned to lender certain payment rights owed to it by plaintiff as collateral security for a credit facility from the defendant lender. The defendant lender made statements regarding the purported failure of the plaintiff to pay its obligations to the borrower to an insurer of certain borrower obligations under the credit agreement. The United States Court of Appeals for the Seventh Circuit held under Illinois law that the lender's statements regarding the plaintiff's alleged default were defamatory per se.

9. **Breach of Confidentiality**. A lender may be held liable for disclosing trade secrets or other confidential information provided to it by a borrower.

F. **Mortgagee in Possession.** When a lender exercises such control over a property as to effectively be considered in possession, it basically subjects itself to the obligations of the owner and may incur liability to trade creditors and others, as well as to borrower for losses on the lender's watch. In order to avoid the potential liability of a "mortgagee in possession," a lender may petition the appropriate court for the appointment of a receiver to manage the property until the foreclosure sale. The standards for obtaining a receiver vary somewhat by state. Generally, a provisions entitling lender to the appointment of a receiver upon an event of default will help the lender obtain the same. Absent such a provision, many states require a showing of waste or imminent harm.

G. **Risks Associated with Exercising certain Contract Rights**

1. **Replacing the Property Manager**. Standard structured commercial real estate loan documents permit the lender to replace the property manager upon an event of default and certain other instances. Absent special circumstances (e.g., verbal commitments from lender regarding the manager), replacing the property manager is the exercise of a contract right and when done in accordance with the loan documents should not subject the lender to liability. However, replacing the property manager, particularly with one that is an affiliate of the lender, would be an indicia of lender's taking control over the property, perhaps to an extent that causes lender to be a mortgagee in possession or otherwise exposes the lender to liability and would be a factor in determining whether or not the borrower had become a mere instrumentality of the lender for purposes of determining equitable subordination or other lender liability.

2. **Exercising Cash Management**. Another structured loan standard remedy is the right to seize control of the cash following an event of default or occurrence of a covenant breach. This remedy is of particular importance to a lender who suspects that the property manager is misappropriating funds or applying funds other than in accordance with the terms of the loan documents. Exercising cash management in accordance with the terms of the loan documents and applying objective standards set forth in the loan documents should not lead to lender liability. Control of the cash is a factor, however, in determining whether or not lender has stepped over the line and is exercising too much control over the borrower. While there is no bright line rule, the exercise by lender of discretion over the use of the cash (e.g., lender determines which vendors to pay and which not to pay) as opposed to simply approving or disapproving borrower requests in accordance with objective standards set forth in the loan agreement is a material bad fact in determining whether lender has exercised such control over the borrower as warrants the imposition of liability, the characterization of it as a mortgagee in possession or the equitable subordination of its lien.

In *Clark Pipe v Associates Commercial Corporation*, discussed above, the court found that although lender admitted it controlled cash in such a way so as to put

itself in the best position possible before bankruptcy, the application of the doctrine of equitable subordination could not be justified because the lender was acting according to the express terms of the loan documents which were negotiated at arm's length and which contained customary terms for transactions of this type. In rendering its decision, the court relied on the fact that, while the lender was controlling the flow of cash to the borrower, the lender did not expressly dictate which bills the borrower was to pay. The same court that handed down the Clark Pipe decision came to a different conclusion in *In re American Lumber Co.*, discussed above. In that case, the court cited the defendant-bank's control over all aspects of the debtor's finances as a key element in its determination that the doctrine of equitable subordination was warranted.

In addition to being exposed to liability or having its lien subordinated, the exercise of cash management in certain states can be detrimental to a lender's right to pursue all other available remedies. In some states (i.e. California), seizing control of the cash and then applying it to pay down the loan can trigger a one-form-of-action rule which can prevent the lender from, inter alia, holding a foreclosure sale or pursuing a deficiency judgment. It is important that applicable state laws be reviewed prior to exercising cash management to ensure that proper state procedures are followed and that all available remedies are being preserved.

H. **Minimize Risks of Lender Liability**

1. **Institute Communication Controls**. Establish a formal line of communication which channels all communications through a designated representative. This will make it easier to measure and monitor potential risk and exposure.

2. **Be Cautious of Oral and Written Communications**. Today's communications may become tomorrow's evidence. Communications should focus on facts and data which are either offered by the debtor or verifiable by the creditor. Expressions of opinion or speculation should be reserved for internal, private conversations which are not documented. Additionally, review borrower communications carefully for attempts to "set-up" the lender, and respond appropriately.

3. **Pre-Negotiation Agreement**. As mentioned above, insist on a pre-negotiation agreement with borrower and guarantors, if restructuring conversations are to be had; and memorialize substantive calls with borrower to clearly spell out necessary conditions or reservations to proposed agreements.

4. **Be Cautious of Expressions of Intent**. Desperate debtors are quick to construe language as a promise or commitment. It is prudent to have counsel circulate notes following a meeting or lengthy negotiation between the parties. The purpose of the notes is not so much to summarize the meeting but rather to emphasize the non-biding and preliminary nature of any discussions.

5. **Involve Counsel Early in the Process**. Counsel can provide valuable controls in the process. Additionally, the attorney/client privilege and, for counsel, the work product doctrine may be used to protect sensitive and frank communications from being opened up to discovery at a later date.

6. **Laws Vary By State**. While this outline discusses the general principals of lender liability, the law varies state by state. In any particular case, the law of the applicable state or states needs to be researched and a local counsel will need to be involved.

7. **Set Objectives.** Adopting mutually approved budgets or agreeing to parameters as conditions to future approvals can strengthen the lender's position that it is not acting arbitrarily nor assuming power to which it is not entitled.

## II. MULTI-LENDER TRANSACTIONS

A. **Allocation of Control Between Lenders**. Lenders can share debt inside the same loan, or outside as separate loans with common collateral. Typically when multiple lenders share a single loan, one lender takes the lead in servicing the loan and dealing with the borrower. Lenders sharing a single loan can either participate by paying the lead lender to purchase interests in the loan, or act as co-lenders by agreeing to lend directly to the borrower. When there are multiple loans, they can be tiered as senior or subordinate debt or as *pari passu* arranged under an Intercreditor Agreement. [3] The co-lender, participation or intercreditor agreement (the "Intercreditor Agreement") in turn governs the relationship among the lenders. Particularly, the Intercreditor Agreement sets forth the rights and duties of the lenders in a work-out situation. Generally, the Intercreditor Agreement governs the relationship among the lenders, but it is important to note that where the relationship is not covered by contract, or where the contract is silent, different forms of multi-lender relationships (e.g., participants versus syndicated co-lenders) are treated differently by the courts (e.g., a co-lender holding a separate note has its own claim against the borrower in a bankruptcy – again subject to the terms of the Intercreditor Agreement). The different relationships between the lenders in shared loans have included secured loans from one lender to the other, loan sales, joint ventures, agency, trusts, and tenancies-in-common. A sharing agreement assumes that the initiator involves the other lender in direct or indirect interests in the single loan. The initiating

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[3] Most states would not impute a duty between the two, and foreclosure of one would not affect the other, meaning foreclosure would be subject to the other lien. Each lender would have privity with the borrower, right of set-off against deposits, and separate mortgagee rights without the need for partition of proceeds. Pennsylvania appears to be the only state where a foreclosure of one simultaneous mortgage would cause foreclosure of the other. "Had these mortgages been made to different mortgagees at the same time, and filed for record at the same instant, there could be no doubt but that the foreclosure of one without making the owner of the other, whether original mortgagee or assignee, a party would not have discharged the other. … [T]here is no good reason for saying that the foreclosure of one of the simultaneous mortgages to different persons shall not satisfy the other mortgage, and that the foreclosure of one of two such mortgages executed to the same person shall work the discharge of the other when assigned to another. 27 Cyc. 303. The courts of but one state so hold, and, as no reason is given therefore in any of the decisions, we are content in saying that we do not care to follow them. See Magaw v. Garrett, 25 Pa. 319; Dungan v. American L. Ins. & T. Co. 52 Pa. 253; Bonstein v. Schweyer, 212 Pa. 19, 61 Atl. 447." *Dahlstrom v. Unknown Claimants,* L.R.A. (1912) 524, 527.

lender commonly originates and structures the loan, initiates the search for other lenders to share in the investment, and continues to be responsible for managing the loan after the other lenders purchase. The initiator's motivation to involve other lenders may be due to a regulatory imposition, such as the one imposed on commercial banks limiting the maximum amounts of credit to a single customer,[4] or the minimum ratio of required reserves to loans. It may be a bank policy or loan committee guideline for the purpose of increasing the number and diversity of loans in its portfolio, or decreasing the amount of any one loan. Additional lenders are attracted because sharing the transaction provides an efficient means of diversifying risk, expanding a portfolio, learning about new customers or new markets being pioneered at the lead's initial expense. There is an assumption, sometimes implicit, sometimes explicit, that loans already approved by a reliable lead as part of its origination do not need the same high level and high cost of scrutiny from the other lenders.

1. **Participation Agreements.** The participation is legally an assignment by the lead of its interest in the loan rather than the assignment of a portion of the loan. Even so, the lead does not retain ownership of the participated interest. This qualification is further supported in the Bankruptcy Code by providing that the lead cannot be deemed to include the participant's interest as part of the lead's estate in a bankruptcy of the lead.[5] The lead retains legal title but transfers equitable title in the loan. The participant receives an interest in the lead's interest, but no privity with the borrower. The participant also has no privity with third party providers such as title insurance companies. This distinction has significant ramifications for the fundamental rights and remedies the participant can exercise both with respect to the lead and with respect to the borrower. Because the lead retains administration and management of the loan, the participant is functionally subordinated as to those powers of the lead, though the lead may have fiduciary duties to the participant[6]. In a participated loan all the stated benefits, such as rights to insurance proceeds, condemnation awards, notice for parties in interest, are expressly held only by the lead-mortgagee. This characteristic distinguishes it from syndicated or agented loans, because in those instances each lender holds a separate direct obligation, though the collateral may be held in the name of an agent entity.

2. **Syndication Agreements.** The syndication is usually reflected by separate notes for each co-lender secured by common collateral held by one agent for the benefit of all co-lenders. Co-lenders have a relationship with the

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4 12 C.F.R. Part 32.

5 "Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under subsection (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold." 11 U.S.C. §541(d).

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originator equivalent to that of a tenant-in-common. This relationship would pass through to the post-foreclosure relationship as well. The dynamic of decision making for administration of the loan is usually a majority vote, with a simple majority threshold for day to day operations, and a super majority for declaring and exercising default remedies against the common borrower. Each lender has privity with the borrower, and potential lender liability. The common remedy available to co-lender for borrower default would be partition after the underlying loans are foreclosed. One additional characteristic available to a co-lender of a syndicated loan is the right to set-off directly against the borrower's debt amounts held by the co-lender.

B. **Lender Liability Claims Among Lenders**.

1. **Breach of Contract**. If a lender fails to perform an act specifically required by the intercreditor agreement, such lender may be liable to the co-lender for its nonperformance. In case of a default by the lead, the participant may have rights of rescission, obligatory repurchase, accelerated damages, periodic damages; and punitive damages for persistent defaults or frivolous litigation by the borrower or lender against the participant. For these contract claims, standard judicial rules for the construction of contracts apply. Absent fraud or other events outside the four corners of the contract, the courts will generally enforce the terms of the agreement based on the original intent of the parties as discerned by the court.

(a) *Continental Bank N.A. v Old Kent Bank and Trust Company*. 1994 WL 710301 (N.D. Ill.). Plaintiff sued defendant claiming defendant's release of collateral following the borrower's event of default was a breach of the terms of the participation agreement. The participation agreement stated that the lender could not, without the consent of the participant, amend, modify or waive any provision of the loan agreement or other loan documents. The court ruled for the defendant, finding that the defendant had the right under the governing documents to transfer, deposit or surrender control of any collateral upon the occurrence of an event of default and thus, the release of the collateral was not an amendment, modification or waiver of any term of the loan documents.

(b) *New Bank of New England, N.A. v The Toronto-Dominion Bank, et al.* 768 F. Supp. 1017 (1991). Lender holding minority interest in a syndicated loan brought action to compel majority lenders to exercise remedies of acceleration and foreclosure. Under the terms of the governing loan agreement, upon a borrower's default, the vote of a majority of the lenders was required to exercise remedies of acceleration and foreclosure. The court held that the minority lender could not compel the majority lenders to accelerate and foreclose and further, provisions in the governing loan agreement against implied covenants, duties or obligations barred the minority lender's claim that majority lender had an implied obligation of good faith to accelerate and foreclose. However, the

court held the minority lender was able to block a modification of the loan documents because the loan documents could not be materially modified "without the written consent of all the lenders."

(c) *First Pontchartrain Savings Assoc. v. Evangeline Federal Savings and Loan Assoc.*, 487 So. 2d 512 (La. App. 1986). Participant lender brought suit for a money judgment against a lead lender for failure to redeem loan participation upon date of maturity. The participation agreement stated that the sale of the participation by the defendant was "without recourse". The court found that the defendant was supposed to redeem the participation ninety days from its purchase. The court explained that the words "without recourse" mean that the endorser is merely an assignor of title to the instrument, and that the endorser is not liable on the default of the maker (i.e. the borrower) but that in the case at hand, the petition is not seeking to enforce an obligation of the underlying contract; rather it I seeking to enforce an independent obligation allegedly created by the contract between plaintiff and defendant and thus the "without recourse" provision is not relevant.

2. **Breach of the Required Standard of Care**. Most Intercreditor Agreements expressly disclaim the lead lender's liability other than for gross negligence and willful misconduct. This language is subject to some interpretation by the courts and some lenders may be held to a higher standard of care, particularly due to the level of sophistication of the involved parties. Courts, however, are reluctant to find the existence of a fiduciary duty between the lead lender and other lenders and even if they do, courts recognize that the relationship can be modified or qualified by the express terms of the contract.

(a) *American Bank & Trust of Coushatta, et al. v FDIC*. 49 F. 3d 1064 (1995). Language in the loan participation agreements that the lead bank would not be liable to other banks so long as it acted in "good faith" did not permit banks to recover from the FDIC (in its capacity as a receiver for the lead bank) for its negligence or even gross negligence and FDIC's actions did not exhibit "intentional maliciousness" required for other banks to recover under the participation agreements.

(b) *Banque Arabe Et Internationale D'Investissement v Maryland National Bank*. 819 F. supp. 1282. (1993). [see below] Court held that in an arm's length transaction between two large financial institutions, a fiduciary duty does not exist unless it is expressly created by the terms of the agreement.

3. **Failure to Disclose and Misrepresentation**. The levels of representation, warranty and indemnity the lead provides to the participant can be a source of contractual breach. There may also be disputes as to implied representations and as to tortious conduct. These in turn are affected by whether the sale of the participation is expressly either without recourse, subject to recourse, or based on

"as-is" condition with limited warranties. One effect is that the originating lender seeks to have the sharing lender confirm its independent investigation and conclusion, or waiver of its right to do so. Though the Federal Home Loan Bank Regulations have left the recourse quality of the sale to the discretion of the parties, the applicable definition in the regulations refers to "with recourse"[7] rather than without recourse. Typically, the right to receive information or to review periodic reports is outlined in the Intercreditor Agreement. Beyond contractually mandated disclosures, the lead lender has an obligation to reveal accurate information based on doctrines in tort law for liability due to negligent or fraudulent misrepresentation. Under general tort law, misrepresentation occurs if one party either unreasonably or knowingly makes a material misrepresentation of material fact on which the other party relies. In some instances, the party making the misrepresentation has to know or have reason to know that the other party is relying upon it.

(a) *Banque Arabe Et Internationale D'Investissement v Maryland National Bank.* 819 F. supp. 1282. (1993). Plaintiff alleged that defendant defrauded it because defendant knew that plaintiff was relying upon information provided by lead lender and that the lead lender had intentionally failed to disclose material (x) certain borrower construction delays, (y) errors in information provided by defendant to plaintiff, and (z) objections to the borrower's condominium offering materials raised by the applicable New York State department. Despite being aware the plaintiff was relying on the information it provided, and that certain information it failed to disclose would be material to the plaintiff, the defendant failed to disclose such information. The court found that because the defendant had "superior knowledge" and further, the information was not "readily available" to the plaintiff, the defendant had a duty to disclose the information to the plaintiff. The court found that the superior knowledge of the plaintiff overcame language in the participation agreement that the plaintiff conducted an independent credit analysis and was basing its decision to purchase the participation interest on its own analysis without reliance on the defendant.

(b) *Banco Totta e Acores v Fleet National Bank.* 768 F. Supp. 943 (1991). Participant sought rescission of participation in a loan on the basis that the lead bank had a duty to disclose that the debtor was under investigation for possible Medicaid fraud. The court ruled against the participant on the basis that the participation agreement contained language that the participation was purchased solely on the participant's independent credit evaluation.

4. **Breach of Implied Covenant of Good Faith**. Agreements between lenders are also contracts as to which the implied covenant of good faith and fair dealing may apply under the same theories as with respect to loan documents

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7 12 C.F.R. § 561.55.

between a borrower and a lender (UCC either directly or by analogy or common law doctrine). The Uniform Commercial Code generally treats participations as purchase-and-sales,[8] though the drafting committee is considering granting the parties the freedom to contract consistent with their intent. The UCC approach has been supported in cases,[9] so that in the context of bankruptcy, the stated intent of the parties to shape the transaction along the lines of a loan, trust, agency, independent contract has been disregarded in favor of the purchase-and-sale.

(a) *Ranier v Mount Sterling National Bank*, 812 S.W.2d 154 (1991), a second mortgage holder sued the first for breach of the duty of good faith and fair dealing. The lenders were parties to a subordination agreement. Subsequent to its execution, defendant lent an additional $75,000 to the debtor without notice to the subordinate lender. The debtor defaulted on the loans and the senior lender foreclosed. The senior lender applied mortgage payments it received first to pay down the new money it had advanced. The court found that the defendant had breached its implied covenant of good faith and fair dealing when it failed to give notice to the plaintiff of its subsequent loan to the debtor and when it unilaterally applied the mortgage payments it received from the debtor first to the unsecured portion of the new promissory note.

5. **Breach of Fiduciary Duty.**

(a) Agency. The agency obligations of the lead with respect to the participant can be expressed, but will sometimes be implied in the event there is an assignment but the documents are otherwise silent.

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[8] *See* "(b) [Security interest in Secured Obligation.] the application of this article to a security interest in a secured obligation is no affected by the fact that the obligation is itself secured by a transaction or interest to which this article does not apply. ***." UCC Revised §9-109(b) (2000); "7. Security Interest in Obligation Secured by Non-Article 9 Transaction. Subsection (b) is unchanged in substance from former Section 9-102(3). The following example provides an illustration.
Example 1: 0 borrows $10,000 from M and secures its repayment obligation, evidenced by a promissory note, by granting to M a mortgage on O's land. This Article does not apply to the creation of the real-property mortgage. However, if M sells the promissory note to X or gives a security interest in the note to secure M's own obligation to X, this Article applies to the security interest thereby created in favor of X, The security interest in the promissory note is covered by this Article even though the note is secured by a real-property mortgage. Also, X's security interest in the note gives X an attached security interest in the mortgage lien that secures the note and, if the security interest in the note is perfected, the security interest in the mortgage lien likewise is perfected. See Sections 9-203, 9-308.
It also follows from subsection (b) that an attempt to obtain or perfect a security interest in a secured obligation by complying with non-Article 9 law, as by an assignment of record of a real-property mortgage, would be ineffective. Finally, it is implicit from subsection (b) that one cannot obtain a security interest in a lien, such as a mortgage on real property, that is not also coupled with an equally effective security interest in the secured obligation. This Article rejects cases such as *In re Maryville Savings & Loan Com.*. 743 F.2d 413 (6th Cir.1984). clarified on reconsideration, 760 F.2d 119 (1985)." UCC Revised §9-109 Comment 7.

[9] Mademoiselle of California, at 665; Heights v. Citizens National Bank, 463 Pa. 48, 63, 342 A.2d 738, 745 (1975).

(b) Participation as Trust. An alternate structure for interpretation of the relationship is that of a trust. If it were a trust, then a higher fiduciary duty by the lead to the participant may be imposed. Current court analysis upholds the doctrine that the lead has a fiduciary duty to the participant but that it is almost impossible to describe.[10] The New York Court of Appeals specifically denied the application of a trust theory,[11] and from a practical point of view the rule is more realistically described as that fiduciary relationships should not be inferred absent unequivocal contractual language.[12] In addition, the participant is effectively equal to, and upon the bankruptcy of the lead, superior to, the lead. Collections made by the lead would be in trust for the participant.

(c) *Stratford Financial Corp. v. Finex Corp.*,[13] established six factors for analyzing whether a trust exists: (1) the words "in trust" are used; (2) participant was not represented by counsel and relied on the lead; (3) Commingling of funds was without the participant's knowledge; (4) the lead promised to keep the obligations owed to the lead and participant separate; (5) there was no note from the lead to the participant. The higher duty of care is also imposed when the lead shoulders the responsibilities of servicing the loan.[14] The participant may want the right to substitute the lead's servicing with another professional. The trust has been considered equivalent to a guarantee by the lead by at least one commentator.[15]

(d) *Jefferson Savings & Loan Association v. Lifetime Savings & Loan Association*, 396 F.2d 21 (9th Cir. 1968). The loan participation agreement between two associations provided, inter alia, that after foreclosure: "Seller may manage, maintain, or dispose of property so acquired in any manner which it shall deem necessary, the parties hereto sharing ratably in the income and expenses thereof." Defendant association foreclosed the trust deeds and then sold under some properties by a contract to which plaintiff-association did not consent. The two associations could not agree upon the amount of money which the plaintiff association was owed upon the sale and plaintiff sued. The court held that defendant association held the whole of the land in its name as a trustee for the plaintiff association and as a trustee, "had no right to place itself in a position where its

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10 Guaranty Savings & Loan Association v. Ultimate Savings Bank, 737 F.Supp. 366 (W.D. Va. 1990).

11 Prudential Insurance Co. v. Liberdar Holding Corp., 72 F.2d 395, 397 (2d Cir. 1934). Consequently, the certificate holder was not entitled to ownership in the real estate unless the lead failed to make payment and the certificate holder exercised remedies against the lead.

12 First Citizens Federal Savings & Loan Association v. Worthern Bank & Trust Company, 906 F.2d 427 (9th Cir. 1990).

13 367 F.2d 569 (2d Cir. 1966).

14 Women's Federal Savings & Loan Association v. Nevada National Bank, 811 F.2d 1255 (9th Cir. 1987).

15 Hutchins, Jeffrey, D., "What Exactly Is A Loan Participation?" 9 Rutgers-Camden Law Journal, 447 at Note 210.

interests were or might be antagonistic to the interest of the beneficiary of the trust". Id. at 24.

6. **Lead Lender as Borrower or Guarantor.** Early cases held that the lead was named as "agent," acted as guarantor of repayment, and the participant held a lien or security interest against the lead's interest in mortgages. It was a collateral assignment of the lead's security, and did not result in a direct assignment of the lead's interest in the mortgage against the borrower.[16] Consequently, after foreclosure of the mortgage loan, the participants were deemed to hold a lien on the lead's fee estate, rather than title co-equal to the lead's in the real estate. But, when the issues were pushed to a further extreme in the arena of a bankruptcy, the Second Circuit backed off of its position where a single large loan was the subject matter of the participation, concluding that undivided shares in a specific mortgage were directly assigned, and therefore, the holders had the rights of a mortgagee to vote on a bankruptcy plan of reorganization.[17] This kind of confusion continues to abound where the documents are silent and the courts are left to find the "intent of the parties."

(a) *In re Sprint Mortgage Bankers Corp.*, 164 B.R. 224, 228 (Bankr. E.D.N.Y. 1994) Investors commenced adversary proceeding against Chapter 7 debtor, a mortgage broker operating in the secondary mortgage market, for determination of their rights to notes, and proceeds thereof, secured by deeds of trust on real property held by debtor who was perpetrating a "Ponzi" scheme. Lead lender made loans using funds from investors, and guarantied investors interest therein or to refund the balance of an investors interest at the face value. Assignment of mortgage interest to investors (participants) were recorded; the mortgage notes were retained by the debtor. But investors were receiving the mortgage assignments in a random order that was not specifically tied to the money which they were investing. Plaintiffs brought suit seeking judicial declaration that the transaction be characterized as a participation such that the plaintiffs each own discrete portions of the mortgages and notes as a result of the assignments of mortgages and that this interest was perfected when the mortgage assignments were recorded. The court held that transactions between investors and debtor were loans rather than true mortgage participations and so investors had unsecured claims for any funds advanced to debtor that were not repaid. In determining this, the court found that several factors were important. A participation is characterized by the following: a) money is advanced by participant to the lead lender; b) the participant's right to repayment only arises when a lead lender is paid; c) only the lead lender can seek legal recourse against the borrower; and d) the document is evidence of the parties' true intentions. In comparison, the following four factors indicate an loan: a) guarantee of repayment by the lead lender to participant, b) participation that lasts for a

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16 People v. Title and Mortgage Guarantee Co., 264 N.Y. 69, 190 N.E. 153 (1934).

17 In re: Westover, Inc., 82 F.2d 177 (2d Cir. 1936).

shorter or longer period than the underlying obligations, c) different payment arrangements between borrower and lead lender and lead lender and participant, and d) discrepancy between the interest rate due on the underlying note and the interest rate specified in the applicable participation. The court found that the transactions at hand clearly fall into the category of a loan and not a participation and thus the investors had unsecured claims in the debtor 's estate only.; In re: Coronet Capital Co., 142 B.R. 78, 82 (Bankr. S.D.N.Y. 1992).

7. **Co-lenders as Joint Venturers.** Another organizational structure which can be applied to the shared loan relationship is that of a joint venture. In the event a joint venture is established, the venturers have an implied fiduciary duty to each other. It is not clear, however, whether that duty of loyalty and duty of care is greater for the joint venture than for a sale of a portion of a loan which is subsequently serviced and administered by the lead. Venturers, like partners, have mutual powers of agency with respect to each other.[18] Another distinctive characteristic of the joint venture is that the venturers share losses. As a result, it is not merely a loss of the investment, but also can be an obligation to pay the share of expenses incurred.[19]

8. **Mortgage Remedies Under Participation**. The participant's rights and remedies for borrower's default and for the lead's default are different. In the case of a mortgagor default, the participant may have rights to compel mortgage remedies, and to collect the first funds from a liquidation ("last in, first out") rather than share with the lead. In the event of mortgagor default, request for prepayment, or defeasance or additional calls for loan advances, the participant may elevate its rights to more closely monitor events, and to accept or decline expansion of the debt, such as Lead's responsibility to simply provide information to participant upon a default by borrower, or requiring vote of majority of the holders of the loan, or super majority or unanimous consensus to takeover remedy or a specific remedy enforcement expenses, voting rights to foreclose or mortgagor or sell loan, release of collateral, waiver of defaults, forbearance or forgiveness of obligations, restructuring maturity, interest, amortization or collateral. Where the borrower seeks to have set-off of deposits held by the lead against the entirety of the participated loan, the participant can object that it has not received the benefit of the deposits, and that the set-off should be limited to the moiety held by the lead, or the participant should have a preferred claim against the portion attributable to the participant's share. Even if that were upheld, when the lead is insolvent, the claim is essentially an unsecured claim.[20]

9. **Senior/Subordinate Lien Impairment Liabilities.** One common law principle is that a senior lien holder generally may not impair a subordinate lien holder without its consent. Impairment occurs upon increase of the term, the debt,

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18 Jager, Joint Ventures, Origin, Nature and Development, 9 Am. U. L. Rev. on (1960).
19 Slaughter v. Philadelphia National Bank, 417 F.2d 21 (3d Cir. 1969).
20 Federal Deposit Insurance Corporation v. Mademoiselle of California, 379 F.2d 660 (9th Cir. 1967).

the interest rate, or the debt service, or increasing other burdens on the borrower. Though substantively forbearance is similar to extension of a maturity debt it is usually not considered an impairment. If it can be recharacterized as an extension it may become an impairment. Remedies for impairment may be to void the modification, void the entire loan as modified, or if the lender is otherwise acting unreasonably, it may be subject to tort actions.

C. **Borrower's Concerns**:

1. **D'Oench, Duhme Doctrine.**

(a) The D'Oench, Duhme doctrine is a principle of federal common law. It was first articulated by the Supreme Court in *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942). The court held that in the case of a person who had a secret side agreement, that the bank would not call its notes, that person could not enforce the agreement against the FDIC and receiver as a defense to payment of the notes to the bank. The *D'Oench, Duhme* doctrine was expanded by court cases to bar a wide variety of both claims made and defenses raised against the FDIC as receiver. In addition, in 1989, as part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), Congress passed its own version of the *D'Oench, Duhme* doctrine, which bars any claim that (1) is based upon an agreement that is either unwritten or, if written, does not comply with statutory requirements, and (2) would impair or imperil the interest of the FDIC in an asset acquired by it as a bank receiver. 12 U.S.C. § 1823(e). The doctrine is still in flux.

(b) The *D'Oench, Duhme* doctrine generally bars enforcement of obligations only when those obligations arise from an agreement, as the term has been broadly construed by the courts (see *Langley v. FDIC,* supra, 484 U.S., at pp. 90-92, 108 S.Ct., at pp. 400-401). A direct relationship, however, is not an essential prerequisite to the applicability of the defense. (See *Chatham Ventures, Inc. v. Federal Deposit Ins. Corp.* (5th Cir. 1`981) 651 F.2d 355, 360-361; see also *Federal Deposit Ins. Corp. v. Dixon* (E.D. Mich 1988) 681 F.Supp. 408 (holding defense applied even though misrepresentations were made by third party and not by bank)).

2. **Lender Default.** Borrowers are also concerned by the inability to enforce a loan against a participant when the lead is in default or in bankruptcy. Though, if the participant defaults, the borrower would ordinarily not be affected in its recourse against the lead to compel its performance.

III. CONCLUSION

A. **Current Trends.** Following the 1984 seminal case of *Farah* (discussed above), courts saw a wave of lender liability cases. Borrowers were continually coming up with

novel theories on which to sue lenders. Many of these cases, while successful at the trial level, were ultimately overturned at the appellate level. Over the past ten or twelve years, the majority of lender liability cases have been limited to more traditional theories of tort and contract law (e.g., breach of contract and fraud) and borrowers have not generally met with much success. The environment of failing banks and failing borrowers makes the permutations of recovery more complex. We are monitoring current developments closely and see some cause for concern that courts may become more borrower friendly in the current economic climate. In addition, borrowers may well find new grounds for complaint based on the frustration of the master servicer to special servicer process. We have already seen borrower's have some success in defending foreclosure actions on the basis that the plaintiff could not establish that it was the owner of the note and mortgage. Generally these cases have been limited to the residential context, but there has now been at least one case involving a commercial loan held by MERS.

B. **Summary.** The risk to lenders of lender liability is real, but generally manageable. Adherence to the loan documents, clear and thoughtful communications with the borrower, proper documentation (e.g., pre-negotiation agreements), and responding appropriately and timely to borrower correspondence can all help to protect against inadvertently incurring liability.

The foregoing outline is a general overview of discussion purposes. It is not intended as legal advice with respect to any fact situation in any particular jurisdiction. Appropriate counsel should be consulted with respect to any specific circumstances.