Lender Liability

Courts Limit Findings, but Potential Traps Remain

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ith the reduced availability of credit, the tightening of lending standards and the downturn in the financial industry and the economy generally, the stage is set for an increased number of real estate loan defaults, foreclosures and workouts. It is thus an opportune time to reexamine the state of the law on lender liability, and to consider when actions taken by lenders in protecting their security or engaging in a workout could expose them to claims of such liability. Although courts have, since the 1980s, tended to limit findings of lender liability, lenders should nonetheless be aware of potential lender liability traps, particularly as they respond to actual or potential defaults on the part of their borrowers.

Assertion of Claims

Claims of lender liability— which are typically, although not exclusively, raised in bankruptcy court—may be asserted in a variety of contexts. Borrowers may bring affirmative claims against lenders based on allegedly wrongful conduct; such claims are generally brought after the borrower is in default and often in the course of an action by the lender to enforce its remedies. Junior creditors of the borrower may raise lender liability claims in bankruptcy court in order to strengthen their own position vis-à-vis a secured lender. Borrowers may also assert lender liability claims as defenses to suits brought by lenders in foreclosure, or may look to the lender to help bear the costs of judgments or settlements in favor of third parties or other creditors.

Third party claims, which are generally brought at any time and in connection with a variety of claims against a borrower (for example, environmental or tort claims).

Types of Liability

A. Control Over Borrower

Lenders are afforded broad discretion to protect their collateral, but excessive control over the borrower and its business can lead to a variety of lender liability claims predicated on the principle that a lender in control of its borrower owes that entity, as well as its other creditors, a fiduciary duty.2 Control is problematic when third parties are purportedly harmed as a result of the lender's actions, or when a borrower who ultimately enters bankruptcy claims that the lender essentially ran the business into the ground. In bankruptcy court, lenders who exercise excessive control may be subject to equitable subordination of their claims, and may be considered insiders, leading to an expanded preference period. In or out of bankruptcy court, lenders exercising excessive control can be joined in suits for aiding and abetting violation of securities and environmental laws and other third party claims under theories of alter ego, joint venture, instrumentality or fraud.

The issue of control is a highly fact-specific exercise,3 but control rising to the level of liability must be "actual, operative, total control"4 of the borrower. Giving business advice, exercising approval rights and closely monitoring the lender's security interest is not sufficient, even if given with the "implicit threat" that the lender would not extend further credit unless its advice is taken, provided that the debtor continues to make its own business decisions and exercise day-to-day managerial control.5 Courts look to the amount and type of influence a lender has over the management of the borrower, for instance, by "stacking" the board with directors loyal to the lender or directing the borrower in its hiring and firing decisions.6

Because lenders are generally permitted to use broad latitude in protecting their security, courts are unlikely to impose liability on lenders who limit their involvement in the borrower's affairs to financial oversight and guidance.7 In Kriko Industrial Supply Co. v. Nat'l Distillers and Chemical Corp., a suit by multiple creditors of a reorganized debtor

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against its major lender, the lender had sent an internal auditor to monitor the borrower, attend management meetings, and establish a system of internal controls for expenditures. The appellate court, upholding a directed verdict for the lender, found that because the auditor’s powers were limited to financial matters and essentially negative in character they did not rise to the level of active, dominant management sufficient to maintain an instrumentality claim.\(^8\)

The lender in *In re American Lumber Co. v. First Nat’l Bank of St. Paul*, on the other hand, was found to have exerted absolute control over the borrower. After the borrower defaulted on its loan, the lender not only commenced foreclosure on its existing security interest in accounts receivables, but forced the borrower to execute security interests in its remaining assets, opened the borrower’s mail, took sole control of the borrower’s bank account, terminated employees, and made all determinations as to which other creditors to pay, based solely on whether payment would enhance the lender’s security.\(^9\)

Because the borrower was found to have no separate corporate existence, and was rather a mere instrumentality of the lender, the lender was subject to various bankruptcy court claims.

It is important to note the distinction between control over a borrower’s cash flow and control over the borrower as an entity. Lenders are permitted to exercise control over cash flow pursuant to negotiated rights, such as those afforded by an assignment of leases and rents or a lockbox arrangement, provided that the lender accounts for and applies the cash in accordance with the terms of the loan documentation and not in the lender’s sole and arbitrary discretion.\(^10\)

### 1. Bankruptcy Law

Findings of excessive control can impair the controlling lender’s position in relation to other creditors of its borrower in bankruptcy court.\(^11\) Transfers from an insolvent debtor to a secured creditor for nominal or no consideration may be deemed “sham” transactions and thus voidable as fraudulent transfers. A controlling lender may be considered an insider and, as such, subject to a duty to deal fairly and impartially with the borrower and its other creditors; if such a lender is engaged in inequitable conduct resulting in injury to other creditors, or confers upon itself an unfair advantage, it may be subject to the equitable subordination of its claim.\(^12\) Inequitable conduct is “that conduct which may be lawful, yet shocks one’s good conscience [...] a secret or open fraud, lack of faith or guardianship by a fiduciary; an unjust enrichment, not enrichment by bon chance, astuteness or business acumen, but enrichment through another’s loss brought about by one’s own unconscionable, unjust, unfair, close or double dealing or foul conduct.”\(^13\)

Where the lender does not exert control over the debtor, inequitable conduct must be egregious and proven with particularity to result in equitable subordination.\(^14\)

Such a finding is comparatively rare as non-insiders have fewer opportunities to engage in the type of conduct that triggers equitable subordination\(^15\) and because a creditor generally owes no fiduciary duty to its borrower or to other creditors.\(^16\)

### 2. Mortgagee in Possession

A mortgagee lender may incur liability not only by controlling the borrower, but through its control of the property itself. In a lien theory jurisdiction such as New York, a mortgagor has the right to retain possession of its property until conveyance, and the lender therefore has no right to possession of the mortgaged property and the incidents thereof until foreclosure. However, after a default, the mortgagor may relinquish its possession to the lender, either by agreeing to do so in the mortgage documents or by consenting at the time of relinquishment, creating in the lender the status of “mortgagee in possession.”\(^17\) A lender who is a “mortgagee-in-possession” collects rents and takes actual or constructive possession of the mortgaged property by undertaking its management and operation.\(^18\) A mortgagee-in-possession is subject to liability to third parties as an owner of property, and has a fiduciary duty to maintain the property in good condition, to act to the standard of a prudent owner, and to not commit waste.\(^19\)

While a lender may wish to become a mortgagee-in-possession in order to protect the property from waste and other harmful actions of the mortgagor, a mortgagee-in-possession bears the risks of ownership, including the potential claim by the borrower that the lender’s actions led to a diminution of the value of the property.\(^20\) A lender seeking to avoid the potential liabilities of a mortgagee-in-possession should be mindful that its actions do not constitute those of possession.\(^21\)

Collection of rents, physical possession and operation of the property can make a lender a mortgagee-in-possession, but even absent physical occupation a lender may be deemed a mortgagee-in-possession by entering into new leases, evicting tenants, or undertaking repairs.\(^22\) As in the case of control over the borrower, whether the lender exercises “dominion and control” over the property rising to the level of possession is a fact-specific inquiry.\(^23\) A mortgagee who is concerned about mortgage-in-possession status may choose instead to seek the appointment of a receiver to manage and collect rents of the property, thus shifting the management of the property to a third party.

### B. Implied Covenant of Good Faith and Fair Dealing

The covenant of good faith and fair dealing is implied in every contract,\(^24\) and breach of that covenant by a lender in the course of its dealings with the borrower may give rise to a cause of action in contract or in tort. In the context of a contract remedy, lender liability issues based on a breach of the implied covenant of good faith and fair dealing often arise when the lender’s rights under the loan documents are undefined, broadly stated or not specifically addressed. Generally, the covenant is not implicated when the contractual terms are unambiguous and clearly define each party’s rights. Parties to a contract “are entitled to enforce the terms of the contract to the letter, and an implied covenant of good faith cannot overrule or modify the express terms of a contract.”\(^25\)

In *Resolution Trust Co. v. Holtzman*, the mortgagor claimed that the mortgagee had breached the covenant by refusing to subordinate its mortgage to condominium documents and allow for partial mortgage releases as units were sold. The purported breach, the mortgagor claimed, led to the failure of its business and the mortgagor’s default under its mortgage. The court found that although the mortgagee provided that the mortgagee could choose to exercise its option to subordinate and
release, whether to do so was in the lender's sole discretion.26

Lender liability based on a breach of the covenant may also arise in connection with the initial negotiation for a loan. An executed, binding commitment letter to make a loan obligates the parties to negotiate the definitive loan documents in good faith.27 Such an obligation is less likely to arise where the potential lender delivers a term sheet which by its terms is non-binding.28

C. Fraud, Negligent Misrepresentation, Fraudulent Misrepresentation

The breach of the covenant of good faith and fair dealing can give rise to a cause of action in tort as well as in contract, but generally may only be sustained where the underlying relationship creates a duty (such as a fiduciary duty) independent of the contractual obligation.29 Absent a showing of excessive control, even a long-standing creditor-debtor relationship is generally insufficient to constitute a fiduciary relationship for purposes of claims predicated on a breach of fiduciary duty, such as negligent misrepresentation of a promise of future conduct.30 However, even in the absence of a fiduciary duty, an action for fraud or fraudulent misrepresentation may lie where a lender (or prospective lender) is found to have "made a promise with a then-existing intention not to perform it" (or, in the case of fraudulent misrepresentation, with reckless disregard for the truth), such as a promise to provide a credit facility of a certain size with no intention of ever doing so31 or making a knowingly empty threat to call the loan.32

D. Oral Modification; Reasonable Reliance; Promissory Estoppel

Lenders should attempt to ensure that changes in repayment terms given as a temporary accommodation to a borrower not be construed as formal loan amendments.33 Similarly, proposals of loan modifications should be clearly couched as mere proposals in order to obviate claims of promissory estoppel, reasonable reliance and breach of contract.34 A well-drafted pre-negotiation agreement can accomplish those ends by providing that any oral or written negotiations, communications or agreements between the parties in the course of the workout are tentative and non-binding until definitive documents have been executed, and that any temporary forbearance by the lender is not a loan modification and can be revoked by the lender under the circumstances described in the pre-negotiation agreement.

Conclusion

Many lender liability claims do not survive summary judgment; courts often grant lenders' motions to dismiss such claims as being without sufficient evidence to support liability.35 Those cases that survive summary judgment tend to exhibit unusual fact patterns and especially egregious behavior by the lender. Lenders that carefully draft loan commitments and documents, choose their words wisely in oral and written communication, and exercise reasonable discretion in protecting their security should generally find lender liability claims against them unsustainable. Nonetheless, lenders and their counsel should remain aware of the potential for lender liability throughout the course of a lending relationship, especially in a climate where borrowers are more likely to find themselves in distress.

References

3. BLANCHARD, supra note 2, at §5.8.
6. 5A J. ROHAN, REAL ESTATE FINANCING §10:06(2)(d)(e) (2007). See, e.g., Fanah, 678 S.W.2d 661 (finding evidence of lender's control of borrower's management sufficient to maintain cause of action that lender had previously caused borrower's damages).
8. Kros, 483 F.2d at 1111; see also In re S.M. Acquisition Co., 2006 WL 2290902 at 5 (N.D.II. 2006).
12. See, e.g., Matter of Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977); American Lumber, 5 B.R. at 477.
16. See generally MADISON, supra note 1, at §14-2. The UCC also makes this duty explicit in all contracts governed by the UCC.
20. ROBERT BOWMAR, MORTGAGE LENDERS IN NEW YORK §16:1 (2d ed. 2007); 1 BAXTER DUNAWAY, THE LAW OF DISTRESSED REAL ESTATE §§11-11 (2004); 77 N.Y. JUR. 2D MORTGAGES §§163, 166 (2008).
21. Id.; ROHAN, supra note 6, at §10:06(1)(a).
24. Id.
25. See generally ROHAN, supra note 6, at §10:06(1)(a).
27. LIABILITy: LAW, PRACTICE, PREVENTION §5:8 (2007).
30. In re Lois, 264 B.R. 69 at 114; see, e.g., BLANCHARD, supra note 2, at §6.2.
31. Fanah, 678 S.W.2d at 681.
32. See, e.g., Village on Canon, 920 E.Supp at 526-7.
33. See 14 A.L.R.3d 307 (1994); Village on Canon, 920 E.Supp at 529.