THEORIES OF LENDER LIABILITY
Pitfalls for Lenders/Lessors to Avoid

I. Introduction

There seems to be no shortage of clever theories to which sharp counsel in search of any deep pocket will rely in an effort to strike it rich. Leasing Companies and Banks are particularly ripe targets of these efforts. Regardless whether it is at the outset of the relationship through to the workout and default stage of a troubled lease or loan, /Lessor's counsel must be cognizant of the fact that Borrower/Lessee/Other Creditor's counsel is looking to your client, and its deep pockets, to bail them out of a bad situation. Whether Lender Liability theories are on the rise or on the decline is really beside the point. What you need to know is where the trouble spots are and how to keep your client out of the line of fire. This outline will point you to some of these areas and the panel will provide common sense best practices you can employ today to minimize those risks.

II. Areas of Liability:

A. Breach of Contract/Oral or Written

Many of the Lender Liability cases are brought by borrowers for failure of the lender or lessor to fund a financing transaction as promised. The courts have found in favor of the lender/lessor where there was no binding contract either because no promise was made, either orally or in writing, or because the contract failed under the Statute of Frauds. If there was a commitment and all conditions were satisfied, the lender/lessor could be liable for breach. Borrowers will also allege alternate theories such as promissory estoppel. Some of the largest recent verdicts however have occurred in the area of a breach of a commitment to lend. See *Mbank Abilene v. LeMaire*, 1989 WL 30995 (Tex.App-Houston) (jury returned $100 million judgment reduced to $69 million by court).

1. *Elements of Breach of Contract*:
   a. Valid Contract
   b. Material breach
   c. Damages
2. *Promissory Estoppel elements*:
   a. A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of a promise;
   b. Which does induce such action or forbearance
   c. Binding if injustice can be avoided only by enforcement of the promise.
3. *Statute of Frauds:* Each state has requirements regarding when commitments to lend must be in writing. For example:
   a. Florida: all Credit Agreements
   b. New Jersey: Commercial loans over $100,000
   c. California: Commercial Lease over $1,000

4. *Breach of the duty of good faith and fair dealing.*
   a. Covenant is implied in written agreements
   b. Proposals and term sheets
   c. Binding commitment
   d. Fulfillment of conditions

Discussion:

Lender Liability may arise when a borrower sues a lender for failing to advance funds under a loan agreement. While most loan agreements are in writing, the claims of lender liability seem to arise from an alleged oral contract or promise to lend or other verbal representation by the lender/lessor. When there is no written agreement, the borrower may prevail on a theory of promissory estoppel, if not barred by the statute of frauds. Although most of the cases appear to be decided in the lender/lessors' favor, some poor procedures and careless actions on the part of lender/lessors have caused them to be subject to prolonged and costly litigation.

The Mark Andrew v. GMAC:

The lender in The Mark Andrew of the Palm Beaches, Ltd. V. GMAC Commercial Mortgage Corporation (S.D. NY, 2003) narrowly escaped liability for failure to fund a $9 million loan for the construction of a continuing care retirement community. Loretta Gardner, a licensed real estate broker and her husband, Dr. Robert Gardner, ("plaintiffs") were working under limited time constraints to obtain a loan for the purchase of one parcel of land needed to complete their construction project. The plaintiffs contend that GMAC's employee, Jim Rice, represented to the Gardners that GMAC would in fact make the loan, if it was structured with a surety bond to guarantee payment, in the method proposed by the Gardners. Mrs. Gardner testified in her deposition that Mr. Rice told her that GMAC would fund the loan.

The loan was to be for interim financing until they could sell units in the complex and obtain permanent financing. When the loan was never funded, the plaintiffs sued GMAC for 1) breach of contract, 2) promissory estoppel, 3) fraud, 4) negligent misrepresentation, 5) bad faith and unfair dealing and 6) failure to exercise reasonable care in processing of loan application. The facts of the case and the discussion by the court are indicative of the mistakes a lender can make and the proper procedures that should be followed to avoid lender liability.

Causes of Action alleging Lender Liability:

1) Breach of Contract. The breach of contract claim was based in part on an alleged breach of a Term Sheet. The parties agreed that the Term Sheet left various items open for future negotiations, including, among other things: the events of default; a default interest rate; the terms of the interest rate cap and its assignment; the surety's subrogation rights in the event of payment of the bond; the drafting of an operating lease; details of the requisite underwriting; and the terms of the surety bond.

The Term Sheet also included various disclaimers. For example, under the title "Committee Approval" the Term Sheet read, "[T]he issuance of any commitment or any other undertaking or obligation of GMAC to make the Loan is subject to the approval of its loan/credit committee." In addition, on the signature page, in bold type, the Term Sheet contained the following language: "This letter is not a commitment to lend, either expressed or implied, and does not impose any obligation on [GMAC] to issue a commitment or to make the Loan. The terms and conditions outlined above are not all-inclusive, but merely reflect the parties' discussions to date, and are subject to change. The issuance of a commitment to make the Loan is subject to full and complete underwriting, diligence, documentation, and loan/credit committee approval."

This language seems to be standard term sheet or proposal language that does not create a binding commitment to lend, and which could not be the basis for a breach of contract action. However, in this case, since the parties were trying to close the loan in a short period of time, the plaintiffs believed they were working under a "fast-track deal" proposed by GMAC, and that no separate commitment letter would be issued.

The GMAC Policies and Procedures Manual contains a provision that contemplates a closing entitled a "Fast-Track Closing." In this manual a "Fast-Track Closing" is defined as an "[u]rgent closing in which the Underwriter directly negotiates the provisions of the Legal Documents without first getting a signed Commitment from the Borrower."

GMAC did not issue a commitment letter after the Term Sheet was accepted by plaintiffs, but instead forwarded draft loan documents to the Garners, who signed them and returned them to the lender, believing that their signatures would close the loan. Luckily, the documents contained blanks for certain terms and were unsigned by GMAC. The documents sent included a Promissory Note, a Mortgage and Security Agreement, an Environmental Indemnity Agreement, an Assignment of Licenses Permits and Contracts, a Guaranty of Recourse Obligations of Borrower, a Debt Service Reserve Agreement and an Assignment of Interest Rate Cap Agreement and Security Agreement.

Amazingly, the court found that "The Promissory Note contains only a promise on the part of the Mark Andrew of the Palm Beaches Ltd. to repay a loan of $9 million, but does not contain a promise from GMAC to make a loan of $9 million…" and "None of the documents identified as the loan closing documents purports to contain any promise or obligation undertaken by GMAC to lend the money to the plaintiffs." So, without a written contract, there was no breach, and the lender was not liable for damages.

2) Promissory Estoppel. The plaintiffs alleged that GMAC made various promises, during the course of the negotiations, that it was committed to funding a loan of $ 9 million, upon which the plaintiffs relied to their detriment. However, the plaintiffs' reliance on the oral representations of the lender that they were on a fast-track basis not requiring a written commitment letter was not reasonable under these circumstances, for the purposes of a $9 million loan. The court found that the plaintiffs' claim was based on oral representations that

allegedly indicated the presence of an oral contract, and that breach of contract claim was barred by Florida's Statute of Frauds.

3) Fraud and 4) Negligent Misrepresentation. These are tort claims that will be discussed later in this outline. In the Mark Andrew case, the court did not find any tortuous acts independent of the breach of contract actions, and dismissed the claims.

5) *Bad Faith and Unfair Dealing.* The plaintiffs alleged that GMAC acted in bad faith and engaged in unfair dealing, in violation of the terms of the Term Sheet, by, among other things, demanding that the plaintiffs provide a surety bond in an unlimited amount rather than simply a bond guaranteeing payments due under the proposed lease, and by requiring that the plaintiffs formally release GMAC from liability before refunding the remaining portion of the good faith deposit, and for failing to forward the Gardners' loan proposal to the GMAC loan committee.

The duty of good faith and fair dealing does not exist where there has been no preliminary agreement reached or where there is no contract between the parties. See Cavallaro v. Stratford Homes, Inc., 784 So.2d 619, 621 (Fla.Dist.Ct.App.2001). In determining whether a preliminary commitment should be considered binding, the court must determine whether there was some expression of an intent to be bound. In this case, the Term Sheet, as a matter of law, did not create a preliminary agreement, and therefore, did not give rise to a duty of good faith and fair dealing for GMAC.

The loan was ultimately declined based on a disagreement over the surety bond proposal. A Commitment Letter may have constituted a preliminary agreement giving rise to the duty, but under the express disclaimer contained in the Term Sheet, GMAC was under no obligation to negotiate in good faith, to have reasonable demands regarding the surety bond, or to give the loan to the GMAC loan committee. The lender's employees seemed to create confusion by their statements regarding the Fast Track Closing, but luckily the court did not consider any of that evidence to create a firm loan commitment.

6) Reasonable Care in Processing of Loan Application. The plaintiffs in this case alleged a breach of this duty but failed to provide any authority to support its existence. There is no common law duty created between a potential borrower and a lender in loan transactions. Claims for negligence can only be maintained if those claims are based on acts separate from those claimed in a breach of contract action.

When is a commitment binding?

In most jurisdictions, in order for a lender to be held liable for breach of contract, there must be a written loan agreement between the parties. Several cases discuss what constitutes a binding written agreement to lend.

A "term sheet" is not a binding commitment to lend. In the case of 50 Pine Co, LLC. v. Capital Source Finance, LLC, 317 B. R. 276, (S.D.N.Y., 2004). A Chapter 11 debtor brought an adversary proceeding against a lender that it had approached about purchase-money financing, and to which it had paid $75,000 deposit, to recover from the lender on

quasi-contract, unjust enrichment or fraudulent transfer theory. The Court found that language in the term sheet executed by the prospective purchaser and lender which it had approached about purchase-money financing, to the effect that the term sheet was for discussion purposes only, was not commitment to extend credit, and was subject to due diligence, credit approval and documentation, was sufficient to preclude any assertion by purchaser that parties had entered into binding preliminary agreement, and barred purchaser from attempting to impose any liability upon lender for refusing to negotiate in good faith.

Letter of Accommodation. Lenders need to be vigilant when issuing any letters to borrowers regarding the status of their credit relationship. In the matter of Freeman Horn, Inc. v. Trustmark National Bank, 245 B.R. 820, (S.D. Miss., 1999). The court found that a bank's "letter of accommodation" was not a binding loan commitment. An adversary proceeding was brought for a bank's alleged breach of purported commitment to restructure a customer's debt, with result that the customer and a related entity were forced into Chapter 7 liquidation. The court did not agree with Freeman Horn, Inc.'s argument that, as a regular borrower from Trustmark, its continuing relationship together with the letter, obligated Trustmark to go forward with the proposed restructuring of Freeman Horn, Inc.'s debt. The letter was written as an accommodation to the borrower to show that it had been approved for an existing line of credit. But the letter did not bear the character of a binding letter of commitment for further extension of credit.

Conditions precedent. Failure by the borrower to satisfy condition precedent can absolve a lender of liability for breach of a loan commitment, if the conditions are clearly spelled out in writing in the commitment, and it is reasonable to assume that the funding of the loan is subject to those conditions. In Transit Management, LLC v. Watson Industries, Inc., 23 A.D.3d 1152, 803 N.Y.S.2d 860, (N.Y.A.D., 2005). Foothill Capital Corporation, the Defendant-Respondent, issued a commitment letter to Watson Industries for a revolving line of credit and a term loan for the purpose of paying off delinquent taxes and existing debt and to provide additional working capital. As collateral, Foothill was to receive a first lien security interest in all of the assets of Watson Industries.

Watson Industries was required, as a condition of the loan, to provide Foothill with evidence that sufficient funds had been applied, or were available, "to bring all federal and state taxes to a current status." Watson Industries did not satisfy the condition precedent with respect to providing written confirmation of firm payoff figures for its state and federal tax liabilities. Thus, based on the failure of Watson Industries to satisfy the condition precedent, Foothill's obligation under the commitment letter never arose. Watson Industries and Benjamin Okwumabua, the Defendant-Appellants, failed to raise a triable issue of fact whether the parties entered into a binding agreement.

B. Tort theories

1. *Tortious Interference with Contract*
   a. Elements
      i. A valid and enforceable contract must exist
      ii. The party charged with interference, the defendant, must have knowledge of the existence of the contract
      iii. The defendant must have intentionally induced a breach of that contract thus rendering performance impossible
      iv. Absence of privilege, justification or an identity of interests
      v. Damages.

See *Vornado PS, LLC v. Primestone Investment Partners, L.P.*, 821 A.2d 296 (Del. Ch. 2002) (applying New York law). If there is an identity of interest with the defendant a cause of action will not lie as one cannot interfere with one's own contract as where parent and subsidiary are such as the parent has control of operations of the subsidiary. See *Grizzle v. Texas Commerce Bank*, N.A. 38 S.W.3d 265 (Tex. App.-Dallas 2001), *rev'd in part on other grounds,* 96 S.W.3d 240 (Tex.2002)

2. *Interference with Prospective Economic Relations*
   a. Elements
      i. An expectancy, reasonable in nature, of entering into a valid and enforceable business relationship with a third party
      ii. The actor's knowledge of that expectancy
      iii. An intentional and unjustified interference with the expectancy by defendant that caused a breach or termination of the expectancy, or injury to the relationship, and in which defendant acted for a wrongful purpose or used dishonest, unfair or improper means
      iv. Damages.

See *Lombard v. Booz-Allen & Hamilton, Inc.*, 280 F.3d 209 (2d Cir. 2002)

Discussion:

It seems like most recent activity in this area centers around a claimed wrongful refusal to release collateral or upon a challenge to a declaration of default. It is typically nothing more than an offensive maneuver by a Lessee/Borrower to escape the provisions of their loan documents. Many courts confuse or combine the two distinct torts into one. Ex Parte Awtrey Realty Co., Inc. 2001 WL 1658318 (Ala. 2001) (setting forth elements of one combined tort by one court). The more usual claim occurs between businesses such as where in *Musa v. Jefferson County Bank*, 620 N.W.2d 797 (Wis. 2001) the jury found interference with prospective economic advantage where the bank defendant had the authority to disapprove a sale of plaintiff's hotel and negotiations with several prospective buyers fell through which plaintiff alleged was the fault of the failure of the bank to provide approval. The bank then foreclosed and plaintiff lost the property to the bank due to the foreclosure.

2. *Termination of Credit*

a. Does loan document allow for it

- Clearly the document should state that discretionary advances may be refused after a default or that a credit can be terminated at lender's discretion after a default without regard to prior waiver of any such rights on earlier defaults.

b. What does lender liability law in jurisdiction say about it

- Familiarize yourself with how your jurisdiction discusses each of these elements as it varies from jurisdiction to jurisdiction. See discussion below.

c. Advance notification to borrower

- Best practices suggest a minimum of 30 days notice to borrower of decision to terminate credit.

d. Is there a payment default or merely only a technical default?

- It is not likely that a court will look favorably on a lender that terminates a credit after notice to the lender of a technical default.

e. Waiver, Estoppel and Course of Dealing by virtue of lender's conduct

- Conduct of lender that suggests waiver or disregard of prior defaults will make the more difficult at a later time to use the existence of a default as a trigger to terminate credit.

Discussion:

Easily the most serious action a lender can take by virtue of the profound effect such action can have upon the borrower and its business. Does the law of your jurisdiction mandate a period of notification before credit is terminated so as to afford the borrower an opportunity to seek a replacement lender? *K.M.C. Co. v. Irving Trust Co.*, 757 F2d 752 (6th Cir. 1985) (applying New York law). Compare the demand note exception as discussed in *Spencer Companies, Inc. v. Chase Manhattan Bank, N.A.*, 81 Bankr 1984 (Bankr. D.Mass. 1987).

3. *Aiding and abetting breaches of fiduciary duty.*

a. Elements of a claim

i Actual knowledge of the aider and abetter that a breach of fiduciary duty had occurred

ii That the bank or leasing company (the aider and abetter) which was not a fiduciary was nevertheless a knowing participant in the breach

iii Damages occur which are proximately caused by the breach

Discussion:

Actual, rather than constructive, knowledge is required to establish the knowledge requirement. In the Adversary Action filed by the Trustee in the NorVergence bankruptcy, a copy of which Complaint is in the materials, the Trustee alleged, in various places, that the Leasing Companies "knew or should have known" many of the facts that the Trustee labeled as fraudulent. In *Lesavoy v. Lane*, 304 F.Supp.2d 520 (S.D.N.Y. 2004), a copy of which can be found in the materials, the Court specifically rejected any notion of constructive knowledge, requiring instead that plaintiff establish the actual knowledge of the defendant charged with aiding and abetting the breach of a fiduciary duty. The *Lesavoy* court stated that "[a]ctual knowledge of a violation is necessary as New York 'has not adopted a constructive knowledge standard for imposing aiding and abetting liability.' Id. at 526 [citations omitted]. It is thus insufficient to assert that the [d]efendants should have known of the misdeeds by the [fiduciaries]. [citations omitted] Thus, [plaintiff] must allege and prove that the [d]efendants had actual knowledge that the [fiduciaries] breached their fiduciary duties and intentionally provided them with assistance in this connection." Id.

"Knowing Participation"

The court in *Sharp International Corp. v. State Street Bank and Trust Company*, 302 B.R. 760 (E.D. N.Y. 2003) elaborated on the knowing participation standard when it stated that "the 'knowing participation' element of the aiding and abetting claim requires more than a defendant's knowledge of the primary violation. To state a claim, a plaintiff must allege some form of participation by the alleged aider and abetter in the primary wrongdoing. Broadly speaking, the case law identifies two forms of actionable 'participation.'

First, aiding and abetting liability can attach where a defendant provides substantial assistance to the primary wrongdoer. 'One provides substantial assistance if he affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables a [breach of fiduciary duty] to proceed.' [citation omitted]. In general, inaction-*e.g.*, a failure to investigate or to alert third parties about another's misconduct-does not constitute substantial assistance, unless the defendant owes a special duty directly to the plaintiff. 'It is well settled that without an independent duty to disclose, mere inaction does not amount to substantial assistance for purposes of determining aider and abetter liability.' *Sharp*, 302 B.R. at 774, citing *Calcutti v. SBU, Inc.* 273 F.Supp2d 488, 494 (S.D.N.Y. 2003).

"Second, even without directly assisting in the commission of the underlying wrong, a defendant may still be liable as an aider and abetter for 'inducing' or 'encouraging' a fiduciary to breach his duties to another. *See Kaufman*, 760 N.Y.S.2d at 169 (holding that a claim for aiding and abetting a breach of fiduciary duty requires, *inter alia*, allegations that the defendant knowingly *induced or participated* in the breach (emphasis in original)." *Sharp*, 302 B.R. at 774-75. The *Sharp* decision can be found in your materials.

Sharp was a closely held New York corporation owned initially by three brothers and thereafter, beginning in 1995, now owned by the three original brothers and an unrelated entity that now owned 13% of the stock in the company. A review of the books and records

of the corporation revealed significant looting, self-dealing and fraud by the original 3 shareholders sometime after 1997 and continuing through October 1999. Some of the fraudulent conduct consisted of inflating revenues used to induce lenders to extend credit to the company, including State Street Bank. Specifically, State Street approved a $20 million line of credit facility and a group of investors extended an additional $17.5 million through the purchase of subordinated notes. Although not in payment default and although otherwise appearing to have oversecured the facility, Sharp nevertheless failed to comply with the accounting requirements mandated by loan documents. Apparently, the concern of State Street was sufficient to involve a workout officer in the credit who, in turn, engaged outside counsel and a financial investigator. The result of that investigation confirmed that Sharp had overstated income and had committed other fraud. State Street then began to carefully scrutinize all of Sharp's activities including requiring receivable confirmations from its customers. Not surprisingly, State Street required Sharp to locate alternate financing to take State Street out.

Sharp then approached the subordinated noteholders and obtained $25 million, of which only $15 million was needed to retire the State Street debt. While this was being arranged, State Street neither informed the subordinated noteholders what its investigation had discovered nor did State Street shut down the line, despite the defaults. The subordinated noteholders purchased an additional $25 million in subordinated notes in March 1999 of which State Street received $12.25 million and promissory notes from the three brothers for the balance of $2.75 million. In July 1999, KPMG refused to issue 1999 audited financial statements and withdrew its 1997 and 1998 audited opinions. Sharp was then placed into involuntary bankruptcy by the subordinated noteholders in September 1999.

Fraudulent Activity:

The trustee filed a complaint against State Street in the bankruptcy alleging that State Street aided and abetted the three brothers in their breach of their fiduciary duties and that the damages amounted to $19 million. In granting State Street's Motion to Dismiss the court found that the complaint failed to plead that State Street had actual knowledge of the brothers' fraud. The court also found that the complaint failed to establish, in the alternative, that State Street either "participated in" or "induced" the three brothers to breach their fiduciary duties. The district court affirmed this decision and the case was appealed to the Second Circuit. The Second Circuit concluded that the complaint failed to sufficiently allege either knowing inducement or participation, 403 F.3d 43 (2d Cir. 2005). The Court divided the three brothers' actions into two distinct areas of fraudulent activity; 1) the borrowing of the funds using fraudulently inflated receivable numbers and 2) looting those funds from the corporation for their benefit of the three brothers. Thus, the court's analysis centered on whether State Street knowingly induced or participated in the brother's looting of the company resulting in the $19 million in damages.

The Second Circuit noted that inducement consisted of "[t]he act or process of enticing or persuading another person to take a certain course of action. [citing Black's Law Dictionary]. A person knowingly participates in a breach of fiduciary duty only when he or she provides 'substantial assistance' to the primary violator. [citation omitted]. Substantial

assistance may only be found where the alleged aider and abetter affirmatively assists, helps conceal or fails to act when required to do so, thereby enabling the breach to occur. The mere inaction of an alleged aider and abetter constitutes substantial assistance only if the defendant owes a fiduciary duty directly to the plaintiff." *Sharp*, 403 F.3d at 50

The Court then reviewed the 5 alleged acts of aiding and abetting alleged in the complaint and the court concluded that the stated nothing "more than that State Street relied on its own wits and resources to extricate itself from peril, without warning persons it had not duty to warn." Id. at 51. The 5 acts complained of were as follows:

1. After learning of the fraud, State Street demanded that debtor find alternative financing to pay off the State Street debt;
2. State Street deliberately concealed its knowledge of the fraud;
3. State Street elected not to foreclose on the loan;
4. State Street avoided the noteholders' repeated attempts to reach State Street in order to discuss the credit; and

State Street, although not required to do so, consented to the purchase of additional subordinated notes by the noteholders and thus participated in the fraud. Id.

"Corrupt Inducement"

The Court concluded that even if true, the first item could not be characterized as participation or substantial assistance and although an inducement, in the broadest sense, such conduct was actually nothing more than a demand to which it was entitled under the loan documents. Id. A "demand for repayment of a bona fide debt is not a corrupt inducement that would create aider or abettor liability." The Court further stated that the legal relationship between a borrower and a lender is that of debtor and creditor and that no fiduciary relationship is established. Consequently, State Street had no affirmative duty to notify anyone of the fraud that it had discovered and, in fact, had every right and obligation to its own shareholders to seek repayment. The fact that the subordinated noteholders did not discover the fraud during its due diligence did not create any obligation upon State Street to inform them of that fraud. Thus, not contacting the noteholders was within its right to refrain from that contact. Finally, because State Street had the contractual right to either insist upon or waive any contract obligation under the loan documents, it had no duty to either foreclose when it first could have or withhold its consent to additional subordinated debt.

4. *Deepening Insolvency*

a. Elements-Discussion

To the extent that deepening insolvency is recognized as a claim, the courts have not yet defined its elements. One commentator has suggested that "[t]he elements may include: (i) an insolvent company; (ii) fraudulent and/or negligent incurrence of additional liability or wrongful dissipation of assets; (iii) prolongation of a company's life through concealment of its deteriorating financial condition; (iv) loss of substantial value that could have been realized if the company's existence had not been prolonged; and (v) harm to the company distinct from the harm suffered by its creditors. Also, courts have not yet addressed whether deepening insolvency is viable on a stand-alone basis or whether the cause of action, even if independent, requires that the defendant commit some other

independently recognized predicate act (i.e., malpractice, fraud, breach of fiduciary duty) which causes 'deepening insolvency' injuries to the company." See James M. Peck, et al., Deepening Insolvency: Litigation Risks for Lenders and Directors When Out-of-Court Restructuring Efforts Fail, 1 N.Y.U.J.L.& Bus. 293 (Fall 2004).

a. *Global Service* case, 316 B.R. 451 (Bankr.S.D.N.Y. 2004) Debtor from inception was insolvent or in the zone of insolvency and Lender should have known that debtor would be unable to repay its loans but loaned it money anyway and obtained additional collateral in the form of a pledge of personal assets from debtor's principals to secure the loan. Bankruptcy trustee alleged that other creditors were induced to extend credit to debtor based on Lender's willingness to extend credit thereby prolonging its corporate existence and increasing its debt that would have been avoided had Lender not advanced funds under these loans. Court held that "prolonging an insolvent corporation's life, without more, will not result in liability under either approach [measure of damages or tort cause of action]. Instead, one seeking to recover for 'deepening insolvency' must show that the defendant prolonged the Company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt...."

b. *RSL COM Primecall, Inc. v. Beckoff*, 2003 WL 22989669 (Bankr.S.D.N.Y. 2003)

c. *Exide Technologies* case, 299 B.R. 732 (Bankr.D.Del. 2003) Delaware Court recognizes a cause of action for deepening insolvency against a lending group of lenders.

d. *R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001) Not merely a measure of damages but a specific cause of action. Described it as "an injury to the [debtors'] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."

5. <u>*Obtaining Additional Security or Enhancing Collateral*</u>

a. See *Stirling v. Chemical Bank*, 382 F.Supp. 1146, 1152-1154 (S.D.N.Y. 1974), *aff'd* 516 F.2d 1396 (2d Cir. 1975). In *Stirling*, the directors and officers of a borrower pursued fraud claims against the lender which had informed them that it would extend additional credit to the corporation and not call existing facilities if the officers and directors executed financing statements to perfect the lender's interests in the borrower's assets and if the current officers and directors resigned. The bank did not keep this bargain.

b. Actions by third parties for the lender's misrepresentations about the borrower's financial condition have also resulted in litigation. Painting a rosy picture to another lender in the hope that the infusion of new capital will allow you to get out of a troubled credit will result in the imposition of liability. See

GMAC v. Central National Bank, 773 F.2d 771 (7th Cir. 1985) or *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793 (3d Cir.1978), *cert den. sub nom. First Pennsylvania Bank, N.A. v. Monsen*, 439 U.S. 930 (1978). It is thus not surprising then that in the *Sharp International Corp. v. State Street Bank and Trust Company*, 302 B.R. 760 (E.D. N.Y. 2003) mentioned above under the aiding and abetting section the lender refused to return the persistent calls of the subordinated noteholders who sought information about the credit since providing no information seems to be safest route to take.

6. *Wrongful seizure of collateral and/or tortious conversion*

a. Elements of Proper Seizure

i. Property right in collateral

a) Importance of doing a search

b) Importance of physical inspection

ii. Default in obligations under security agreement or other document

iii. Court Approval of Writ of Seizure or Replevin

a) *Fuentes v. Shevin*, 407 U.S. 67, 92 S.Ct. 1983, 32 L.Ed.2d 556 (1972). Prejudgment replevin statutes of Florida and Pennsylvania resulted in a deprivation of property without procedural due process insofar as they denied the right to prior opportunity to be heard before chattels were taken from their possessor.

b) The fact that UCC Sections 9-609 and 9-610 involve only secured transactions between contracting parties does not mean that prejudgment seizure of goods without a prior hearing, pursuant to such sections, is constitutionally valid. A statute providing for repossession without notice or hearing is not exempt from constitutional scrutiny merely because its operation is confined to situations involving the presence of a contract. A signed contract may represent a waiver of constitutional rights where the contracting parties are of equal bargaining power, but not in the case of "adhesion contracts" in which the terms are specified by the seller or lender. *Adams v. Egley*, 338 F.Supp 614 (S.D.Cal.1972)

iv. Maintain the peace upon seizure

- See *Jordan v. Citizens and Southern National Bank of South Carolina*, 298 S.E.2d 213 (1982) (breach of the peace as contemplated by statute authorizing secured party to proceed without judicial process in taking possession of collateral if such can be done without breach of the peace, refers to conduct at or near and/or incident to seizure of property.

v. Prompt and Commercially reasonable sale

In order for secured party to first meet its burden of proving every aspect of sale of repossessed collateral to be commercially reasonable, it must establish affirmatively that "terms" of sale were commercially reasonable; this includes burden to show that resale price was fair and reasonable value of collateral under revised Article 9 (see 9-610(b)). *Granite Equipment Leasing Corp. v. Marine Development*, 230 S.E.2d 43 (Ga.App. 1976). For the Article 2A treatment, see 2A-525 and 2A-527.

Discussion:

Repossession of collateral without prior notice to the borrower does not violate the obligation of good faith and fair dealing because 9-609 of the UCC and the security agreement authorized such action. Even though the lender had repeatedly accepted delinquent payments and had twice extended the maturity date of the loan, the lender was free to seize its equipment. *Van Bibbler v. Norris*, 275 Ind. 555, 419 N.E.2d 115 (1981).

III. Documentation

A. Structuring the Loan/Lease Agreement

Borrowers and Lessees have made claims against lenders and lessors based on alleged breach of oral and written commitments, enforcement of unconscionable clauses and other complaints based on the lender's or lessor's documentation. But in most cases, where the financier follows policy and implemented procedures in good faith, standard clauses in documents are upheld. The key is in drafting the lease and related documents in a consistent manner using established language.

1. *Proposals, Term Sheets and Commitment Letters*

a. In order to avoid liability for breach of an agreement to lend, written proposals must contain language stating that it is not a binding commitment. Following is suggested language for the introductory paragraph in a lease proposal:

> "This proposal is subject to (1) formal approval of Lessee's credit by Lessor, (2) the negotiation and preparation of documentation acceptable to Lessor and its counsel, (3) the non-occurrence of any material adverse change in the financial or business condition of Lessee, and (4) the financing terms and conditions set forth in this proposal.

And for the closing paragraph:

> "Except for Lessee's agreement with respect to Lessor's retention of the Lese Deposit as payment of expenses, this letter does not create any legal rights or obligations upon either Lessee or Lessor."

b. A Commitment Letter should contain the specific conditions to fund the lease or loan and certain general conditions. If the conditions are clearly set forth in writing between the parties and are not satisfied by the borrower, the lender will have no liability to fund the loan. For example:

- "From the date of this commitment letter to the date of any commencement, there shall not have occurred any material adverse changes in the Lessee's business or financial condition. Lessor retains the right to delay or to cancel lease funding commitments if such adverse changes have impacted or may impact Lessee's credit capability."

- "This commitment is subject to the negotiation and preparation of documentation acceptable to Lessor and its counsel. If this commitment letter is not signed and returned to Lessor within 10 days from the date of this letter, the terms and conditions of this commitment are subject to change.

- "Funding of this commitment is subject to Lessor's receipt of the following documents: Lessee's current Articles or Certificate of Incorporation, most recent financial statements and capitalization table and insurance company contact information."

2. *Jury Trial Waivers*

Jury trial waivers are disfavored, strictly construed and often set aside. See *Aetna Insurance Co. v. Kennedy*, 301 U.S. 389, 57 S.Ct. 809, 81 L.Ed. 1177 (1937) and *First Union National Bank v. United States,* 164 F.Supp2d 660 (E.D.Pa 2001) (there is a presumption against the validity of jury trial waivers; courts do not uphold such waivers lightly and the burden of proving that a waiver was made both knowingly and intelligently falls upon the party seeking enforcement of a waiver of a jury trial clause). See also National Equipment Rental Ltd. v. Hendrix, 565 F.2d 255, 258 (2d Cir. 1977) (applying New York law). If a waiver is not upheld, the jury may learn of the attempt to prevent a jury trial and assume that the party seeking to avoid a jury has a suspicious reason to keep the issues from them thus providing a distinct disadvantage to that party.

Jury trial waivers must be knowing, voluntary and intentional under federal law. If the waiver language looks like the rest of the loan documentation boilerplate or appears to be the result of an inequality in bargaining power, it will not likely be enforced. Jury trial waivers should be in clear, conspicuous and bold language, specifically called to the attention of the borrower and even require the borrower to initial the waiver paragraph unless such language is directly above the signature line. A separate document with a jury trial waiver while better, is likely impractical. Also when balanced against a constitutionally guaranteed right, do not expect that the court will enforce the parol evidence rule and prohibit the introduction of such evidence to establish that consent to the jury trial waiver was freely given.

3. *Choice of Law/Choice of Forum*

In marked contrast to jury trial waivers, choices of forum provisions are presumptively valid under federal law. Lately, such provisions have met with mixed success under state law, especially the floating forum selection clauses that were universally pervasive in the NorVergence Equipment Rental Agreements. Consequently, unless obtained through fraud or overreaching, or if the clause would violate a strong public policy of the forum or would result in such inconvenience to a party as to effectively deny that party a day in court, they will be upheld. Because forum selection clauses in federal courts are procedural rather than substantive, federal courts will uphold them in both federal question and diversity jurisdiction cases.

4. *General Insecurity Clauses*

UCC Section 1-309 provides that a term providing that one party or that party's successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or when the party "deems itself insecure," or words of similar import, means that the party has power to do so only if that party in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against which the power has been exercised.

Another popular clause in commercial leases is the "material adverse change" as an event of default. Borrowers will try to delete these from the contract or quantify the clause with financial covenants and ratios, but lenders have been successful in leaving the decision to the lender's discretion, especially if they relate the change to the business's financial condition at the time of credit approval, or to changes in key employees.

These general insecurity clauses invite litigation, especially because they are applied subjectively. Such a clause was upheld in Watseka First National Bank v. Frank Ruda et al., 135 Ill.2d 140, 552 N.E.2d 775, 142 Ill.Dec. 184, 58 USLW 2503, 10 UCC Rep.Serv.2d 1073, (Supreme Court of Illinois, 1990). A Secured creditor brought an action on a guarantee. The debtor was unable to meet its obligation based upon a small yield on the farm caused by drought the and guarantors refused to cooperate in the liquidation of farm land to raise funds to apply to the debt as was discussed at a meeting with lender, debtor and guarantors. On appeal, the Supreme Court, Ryan, J., held that the test for whether the lender accelerated debt in good faith pursuant to an insecurity clause was subjective, and that the creditor's action was in good faith.

5. Guarantees

Individual or corporate guarantors of a commercial obligation may bring lender liability claims for accepting forged signatures on a guarantee, that the terms of the underlying obligation were changed, or that the lender wrongfully accelerated the guarantee. In Sees v. Bank One, Indiana, N.A., 839 N.E.2d 154. (Ind.,2005), the guarantor, John Sees, insisted that he signed the document only after receiving an oral assurance from a loan officer that the purpose of the guaranty was to provide leverage to guarantee his brother Robert Sees' cooperation in the event of corporate default. The guarantor also filed a cross motion for summary judgment contending that the assurance amounted to an oral modification of the guaranty agreement.

The case is interesting because it references Indiana's Lender Liability Act which provides the rules under which a debtor may assert an action against or a defense to a creditor's claim arising from a credit agreement. "Sees does not dispute that he is a "debtor" and that the guaranty agreement is a "credit agreement" within the meaning of the statute. Sees contends, however, that he is not attempting to "bring an action" on the guaranty agreement but is instead seeking to interpose an affirmative defense to Bank One's claim." The court agreed with his right to the defense, and also reversed the trial court's judgment in favor of the bank, to which two justices dissented.

Avoid Liability:

Careful drafting of guarantee agreements can avoid liability on these claims. All guarantees should contain a clause to the effect that:

> "This Guaranty is absolute and unconditional, and the liability of the undersigned hereunder shall not be affected or impaired in any way by any of the following; each of which Secured Party may agree to without the consent of the undersigned: a) any extension or renewal of the Agreement whether or not for longer than the original period; b) any change in the terms of payment or other terms of the Agreement or any collateral therefor or any exchanged, release of, or failure to obtain any collateral therefor, c) any waiver or forbearance granted to Customer or any other person; and d) the application or failure to apply in any particular manner any payments or credits on the Agreement or any other obligation Customer may owe to Secured Party. "

6. *"Hell or High Water" Clauses*

a. *C and J Leasing Corp. v. Hendren Golf Management, Inc.* (Court of Appeals of Iowa, No. 6-921/06-0249, filed January 31,2007). Brett Hendren acquired two beverage carts for his golf courses from Royal Links, Inc. C and J Leasing provided the financing, and the documents contained a "hell or high water" clause, to the effect that Hendren would be liable for payment under the contract no matter what happened to the equipment, and notwithstanding any agreement with Royal Links to pay Hendren advertising profits.

The court considered several factors in deciding whether the agreement was unconscionable, including whether it was a finance lease or "something else." Since "hell or high water" clauses in commercial finance leases were enforceable in Iowa, and the contract included language in capital letters that the agreement is to be construed as a finance lease under the UCC," the court concluded that the equipment lease agreement was a finance lease.

So, when including such a clause in a lease agreement, it should be in bold capital letters on the first page of the lease, to avoid liability for trying to enforce an unconscionable contract. For example: **THIS IS A NONCANCELABLE/IRREVOCABLE LEASE, THIS LEASE CANNOT BE CANCELLED OR TERMINATED.**

PANEL:

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