

## CREDIT: Old docs can bring lender liability

Recent cases spur review of your “tried and true” loan contracts

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An Illinois construction finance case exposes some weak spots in documentation that your bank may share. And a Dodd-Frank point on mortgage lending could have spillover effects for commercial real estate lenders.

The recent \$75 million dollar judgment against Delta Community Credit Union in Georgia reminds lenders that disgruntled borrowers and guarantors still bring lawsuits against banks and other institutions as a means of either avoiding liability or actually seeking affirmative recovery against their lenders. While it is too early to know whether the judgment will stand up on appeal, there are various lessons to be learned from examining the current lender liability theories being used by borrowers.

### Angles of attack

Obligors generally tend to go after lenders on one of several grounds.

1. Breach of contract. This is the most common gambit, arising out of a difference of opinion over how funds are to be advanced under a credit agreement, or on how they are to be repaid.

Related to breach of contract claims are allegations of the violation of the obligation of good faith and fair dealing. The obligor argues that while a lender may be acting in accordance with the technical terms of the loan documents, it using its discretion to deprive the borrower of the terms of the bargain it thought it was getting from the lender.

2. Tort claims. Tort claims generally involve an additional duty owed by a party to another, such as an obligation not to engage in negligent conduct which might lead to injury.

In the context of a credit transaction, the lawsuits typically allege that the lender owed the borrower or guarantor some type of duty not to allow the obligors to enter into what turned out to be a failing business transaction. Likewise, obligors may argue that a lender administered the loan in a negligent fashion, thereby causing the borrower damages.

3. Fiduciary duty claims. One of the hot areas of litigation right now is in the area of fiduciary duty.

Traditionally, courts have held that lenders owe no fiduciary duty, absent certain special fact situations, to borrowers or guarantors. Therefore, they have held, there is no duty of a lender to forewarn a borrower that a particular loan transaction or enterprise might be risky.

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While this theory is enshrined in commercial law, we are now seeing legislative action in the consumer lending arena to the contrary. For example, Title XIV of Dodd Frank requires the Federal Reserve to write regulations that will prohibit mortgage originators from steering any consumer into a residential mortgage loan that the consumer lacks a reasonable

ability to repay. Failure to do so may result in damages being assessed against the lender. As a practical matter, such failure may also make it more difficult to enforce the underlying mortgage.

Here is the concern for commercial lenders: Once the dike is opened on the consumer lending side, will it spill over to commercial lending?

How borrowers may come at your bank

A good illustration of the type of legal theories that borrowers present against lenders was found in the 2011 Illinois case of LaSalle Bank, N.A. v. Paramount Properties. In that case the lender extended credit in the amount of \$6.5 million to the borrower to build a subdivision, known as Amberly Woods, in Jefferson County, Mo. The developer's principal signed a personal guaranty.

The borrower proposed to develop the project in two phases. The first phase contained 119 lots, while the second phase would have 114. The developer contracted with another company to prepare the real property for sale to third-party home builders.

The loan documents contained typical provisions for construction loans. This included statements to the effect that advances would be made available to the borrower on written or verbal requests that the lender believed in good faith to come from properly authorized representatives of the borrower, whether or not that was actually the case. Requests for advances were intended to cover the actual cost of the development work on the property.

As is typical in projects of this type, the lender employed a title insurance company to act as escrow agent, to process loan advances. The escrow agreement was entered into among the parties and contained budgets for each of the phases as well as a schedule for disbursing funds and specifically named the agent that was entitled to request advances.

The developer eventually defaulted on the loan obligations. The lender filed suit on the note and against the guarantor. The obligors raised a number of interesting lender liability defenses that revolved around the following factual allegations:

1. The loan was made with a 92% loan-to-value ratio, in violation of the lender's internal credit guidelines.
2. The lender was aware of cost overruns, but failed to notify the guarantors.
3. The lender never performed an inspection of the project, even though the loan documents authorized it to do so.
4. The lender made advances in excess of budget for phase I construction.

5. The lender orally agreed to modify the terms of the loan to increase the amount but allegedly reneged on that promise.

6. The lender managed the loan in the manner that it did simply because it was trying to market itself for acquisition by a larger bank.

More specifically, the obligors asserted that they were entitled to recover damages and to avoid liability under a number of different legal theories.

The first legal theory was one of simple negligence.

The obligors claimed that the lender owed them a duty to administer the loan with the same care and skill that "an ordinarily careful lender" would do in a similar situation. They argued that the lender had been negligent by approving and advancing funds in violation of its own internal credit policies. The court, in reviewing the claim, noted that it could find no case law in Illinois where a court recognized such a claim. The court held that Illinois does not, and "would not, recognize a general duty of care owed by lenders to borrowers, especially not one that would create tort liability based on internal lending guidelines."

Another claim was one based on negligent misrepresentation.

The obligors argued that loan officers of the bank had made oral statements that the bank would extend additional financing over and above what the loan documents called for. This claim was defeated by application of the Illinois Credit Agreements Act. This Act is commonly referred to as a statute of frauds and is found in most states. Essentially, the statute provides that a commitment to lend money is not enforceable unless it is in writing.

The obligors had better luck with a claim relating to breach of the express terms of the loan documents. The breach was premised upon an allegation that the lender failed to require properly completed requests for advances; failed to adequately inspect the project; and allowed overruns to occur. Countering these points, the bank argued that the use of requests for advances or inspections of the property was solely for the benefit of the lender. The court found, however, that the provisions of the loan documents themselves did not make it clear that these provisions were solely for the benefit of the lender; thus, the plaintiffs' claims would survive the lender's request to dismiss them.

The final claim to be reviewed by the court was that of an implied duty of good faith and fair dealing.

The court summarized the theory of good faith and fair dealing by saying that it rested upon a determination that one

party is vested with discretion in how they perform the contract and they should not “exercise that discretion in bad faith, unreasonably, or in a manner inconsistent with the reasonable expectations of the parties.”

The borrowers argued that the lender had unlimited discretion to decide what type of documentation it would require prior to advancing funds and that the failure to conduct basic inspections, even though cost overruns were occurring, was contrary to the expectations of both borrower and guarantors. The court determined that the obligors’ claim would not be dismissed and that they would be able to present evidence at trial as to what the reasonable expectations of the parties actually were.

### The Delta Community Credit Union case

In the Delta Community Credit Union case cited above, the borrower and guarantor were able to convince a court in a non-jury trial that a breach of contract had occurred.

The breach revolved around the issue of whether the loan documents were intended to be a true demand obligation or whether they evidenced a term note. The court determined that although the promissory note was called a demand note, the parties did not intend for it to be treated in that fashion. While an instrument may indicate that it is a demand note courts are likely to review evidence that the parties did not intend the instruments to be demand notes when the loan documents contain covenants and provisions which are more typical of a term obligation.

### Addressing underlying causes of lender trouble

In both of these transactions the negative outcomes for the lenders were at least in part the result of loan documents that had not been completely thought through, as well as loan administration practices that were not finely tuned to legal risk minimization.

One of the issues in reducing legal risk is reviewing loan documents that have been in use for years and asking questions about those documents in light of new realities.

The reality is that because most loans get paid as and when due, lenders do not have frequent opportunities to have their loan documents or their loan procedures reviewed by a court and a certain complacency can set in. As with certain other internal testing that banks do to confirm that their systems are operating as expected, they should also periodically ask questions about their loan documentation, the assumptions that the use of documents are premised on, and whether current attitudes have changed towards the use of certain types of documents.

For example, the use of demand notes in the context of a commercial transaction involving a real estate project may simply present too many challenges today in many states. The fact that no one has challenged their use in a particular locale does not mean that the documents will be readily enforceable if and when a dispute occurs.

As part of good enterprise risk management banks should periodically have their loan documents and practice reviewed in light of current legal case law as well as how they are actually doing business and administering loans today. This is particularly important if the institution is the result of several mergers where various systems and document systems have been combined over the years.

#### About the author

Jerry Blanchard focuses his practice on financial institutions. He advises clients on all aspects of commercial and private lending, collections, troubled debt restructuring, distressed loan sales and bankruptcy management. He has dealt extensively with state and federal laws and regulations such as anti-tying, privacy and Sarbanes-Oxley. He is the author of *Lender Liability: Law, Practice and Prevention* and is co-author of *Problem Loan Workouts*, both published by West. He is a frequent speaker in the areas of loan documentation, bankruptcy and lender liability and is experienced in the investigation of financial frauds and scams.

Prior to joining the firm, Mr. Blanchard served as Associate General Counsel for Bank of America Corporation, where he managed a team of lawyers providing legal support to Middle Market Banking, Small Business Banking, Dealer Finance and Private Lending client groups following the merger of Bank of America and FleetBoston.

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