2018 Stevens & Lee/Griffin Banking Institute

Lender Liability: Pitfalls and How to Avoid Them

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Avoiding Lender Liability

This presentation will focus on:

• What is lender liability?
• In what context does it typically arise?
• How can you avoid it?
What is Lender Liability?

• Lender liability is where a lender or prospective lender is sued by a borrower or prospective borrower for contract breaches, tortious behavior, violations of state and federal statutes, and other alleged wrongful behavior
How Does Lender Liability Arise?

Traditional Legal Theories

• Breach of Contract
• Breach of Duty of Good Faith and Fair Dealing
• Fraud / Negligent Misrepresentation
• Unfair Trade Practices and Consumer Protection Law
• Breach of Fiduciary Duty
Breach of Contract

- The most commonly litigated lender liability claims are for breach of contract
Breach of Contract – Common Examples

Pre-Loan Conduct

• Failing to perform (i.e. loan money) according to the terms of the commitment letter or term sheet
Breach of Contract – Common Examples (cont’d)

Conduct During Loan Administration

• Refusal to disperse funds
• Refusal to provide permanent modification after compliance with trial period
• Charging different rates than those set out in agreements
• Misapplying payments
• Rejecting loan payments
• Refusing to refund fees and charges
• Failing to extend loan
Breach of Contract – Common Examples (cont’d)

Conduct When Loan Is In Trouble

• Improper reaction to default – technical v. material
• Improper acceleration of loan payments
• Improper foreclosure on collateral
• Will the lender’s action lead to the destruction of the business?
Breach of Contract

• The best way to avoid these claims:
  • ALWAYS consult the terms of your agreement and your lawyer before acting
  • ALWAYS act in good faith and communicate with the borrower frequently
Breach of Duty of Good Faith and Fair Dealing

• Every contract imposes a duty of good faith and fair dealing, and neither lender nor borrower may do anything to deprive the other of the benefits of the agreement.

• In Pennsylvania, a good faith and fair dealing claim is considered a breach of contract claim, and typically arises when the borrower alleges that the lender violated a term that is not expressly set forth, but is implied in the loan agreement.

Breach of Duty of Good Faith and Fair Dealing (cont’d)

Generally arises in parts of the contract where the lender has discretion in the administration of the loan, such as:

- Accelerating the amount due under a note when the lender feels insecure
- Failing to give reasonable notice when refusing to advance additional funds
- Decision not to extend maturity date
- Decision not to modify/restructure a credit facility
- Decision not to waive covenants in agreement
- Decision not to release its lien on assets
Fraud / Negligent Misrepresentation

- Fraud claims can arise when there is an alleged misrepresentation of fact or concealment of a material fact.
- The hallmarks of a fraud claim are the Lender’s knowledge of the falsity of the fact, intent to deceive the borrower, and the borrower’s justifiable reliance.
- Statements made by the Lender, without a reasonable good faith basis for believing it to be true, even if unintentional, could result in negligent misrepresentation claims.
Fraud / Negligent Misrepresentation
Common Examples

• Inducing a borrower to provide additional collateral under false pretext

• A promise not to foreclose on the collateral, then later foreclosing

• A promise to work with the borrower if the borrower foregoes certain rights (i.e. bankruptcy protection)
Fraud / Negligent Misrepresentation

• Best way to avoid these claims
  • Do not make promises outside of the terms of the loan agreement
  • Document discussions to make clear that no promises are being made and all rights are being reserved
Pennsylvania’s Unfair Trade Practices Consumer Protection Law (UTPCPL)

• In consumer lending, the UTPCPL prohibits unfair and deceptive trade practices

• Although there are several specifically enumerated ways to violate the UTPCPL, the most common claimed against lenders is under the “catchall” provision, which prohibits “engaging in any other fraudulent or deceptive conduct which creates a likelihood of confusion or of misunderstanding”
UTPCPL (cont’d)

- Last month, the Superior Court ruled that the “catchall” provision imposes STRICT LIABILITY on vendors who deceive consumers by creating a likelihood of confusion or misunderstanding.
- Plaintiffs no longer need to establish any state of mind on the part of the lender.
  - If the actions by the lender create a likelihood of confusion or misunderstanding and the borrower reasonably relied on that action, causing damages, the lender will be liable under the UTPCPL.
Breach of Fiduciary Duty

- Fiduciary: a person holding a position of trust and confidence who is invested with rights and powers to be exercised for the benefit of another person

- Fiduciary Duty: when one party must act as the agent for another, the agent is entrusted with the care of property or funds
Breach of Fiduciary Duty (cont’d)

• General rule: debtor/creditor is not a fiduciary relationship

**BUT**

A lender may owe a fiduciary duty to a borrower if the lender asserts substantial control over the borrower's business affairs. Control over the borrower is demonstrated when there is evidence that the lender was involved in the actual day-to-day management and operations of the borrower or that the lender had the ability to compel the borrower to engage in unusual transactions.
Breach of Fiduciary Duty (cont’d)

Examples of when a duty may arise:

- Lender acts as financial advisor on business decisions (deal structure and tax advice) to unrepresented borrower
- Lender drafts legal documents for borrower (lease, operating agreement, etc.)
- Lender controls decision-making process (advises borrower on when and how to purchase equipment and inventory for the business)
- Lender decides which vendors are paid and when
The Best Defense Against Lender Liability Claims

- The best defense against lender liability claims are loan documents drafted in anticipation of lender liability claims.
- Some key provisions include:
  - Integration
  - Disclaimer
  - No Oral Modification
  - Waiver
  - Jury Trial Waiver
  - Jurisdiction and Venue
  - Counterparts
Loan Document Clauses – The Integration Clause

- To combat claims based on facts arising outside of the contract (i.e. fraud and negligent misrepresentation), most contracts have an “integration” clause that state that the written contract is the entire agreement between the parties:

“This instrument constitutes the entire agreement among the Parties relating to the subject matter of this Agreement and there are no agreements, understandings, warranties or representations among the parties relating to the subject matter of this Agreement except as set forth herein.”
Loan Document Clauses – Disclaimer

- In addition to integration clauses, a statement by the parties disclaiming reliance on supposed representations help defeat fraud and negligent misrepresentation claims:

“The Borrowers are not relying on any representations, either written or oral, express or implied, made to any of them by the Lender, any agent or representative of the Lender, other than what is expressly set forth in this Agreement, and the Borrowers disclaim any reliance upon any representations that are not expressly set forth in this Agreement.”
Loan Document Clauses – No Oral Modification

• To combat claims based on alleged modifications or amendments to the written agreement, many contracts have a “no oral modification” clause:

“No, this Agreement nor any of the provisions hereof can be changed, waived, modified, amended, discharged or terminated, except by an instrument in writing signed by the Party against whom enforcement of the change, waiver, modification, amendment, discharge or termination is sought stating that the Agreement ‘is to be changed,’ ‘is to be waived,’ ‘is to be modified,’ ‘is to be amended,’ ‘is to be discharged,’ and/or ‘is to be terminated.’”
Loan Document Clauses – Spouses

• In Pennsylvania, husbands and wife typically own property as “tenants by the entireties”
• Such property can satisfy a judgment only when both spouses agree to responsibility for payment of the loan

“I hereby understand and agree that this guaranty agreement is intended to create a joint liability with the guaranty executed by [guarantor #2] on [date]. I hereby permanently and irrevocably waive any protections of tenancy by the entireties to which I may be entitled, to the extent that those protections are applicable now or may be applicable in the future. I understand and acknowledge that, should [lender] obtain a judgment against me for liability on this guaranty agreement, assets that are jointly held by me and [guarantor #2] by the entireties can be executed upon by [lender] in satisfaction of the debt referenced herein. I agree to promptly execute a joint written guaranty agreement along with [guarantor #2] upon [lender’s] request.”
Loan Document Clauses – Waiver

- Lenders often prefer to work with borrowers when the borrower appears to be at risk or the loan goes into default.
- Waiver clauses allow lenders to give borrowers some leeway without prejudicing their rights.

“No delay on Lender’s part in exercising any right hereunder, and no notice or demand which may be given to or made upon Borrower by Lender with respect to any right hereunder, shall constitute a waiver thereof, or limit or impair Lender’s right to take any action or to exercise any other right hereunder, without notice or demand, or prejudice Lender’s rights as against Borrower in any respect.”
Loan Document Clauses – Jury Trial Waiver

• Jury waiver language must be mutual and conspicuous to be enforceable:

“WAIVER OF JURY TRIAL. BORROWER AND LENDER EACH HEREBY WAIVES ITS RIGHT TO A JURY TRIAL ON ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT OR THE TRANSACTIONS CONTEMPLATED BY THIS AGREEMENT. IN THE EVENT OF LITIGATION, THIS AGREEMENT MAY BE FILED AS A WRITTEN CONSENT TO A TRIAL BY THE COURT.”
Loan Document Clauses – Jurisdiction and Venue

• As the Lender, you want to control where litigation will be filed to the extent possible

“Any Proceeding relating to this Agreement or the enforcement of any provision of this Agreement shall be brought or otherwise commenced only in any state or federal court located in the Commonwealth of Pennsylvania. Each party (a) expressly and irrevocably consents and submits to the jurisdiction of each such court, and each appellate court located in the Commonwealth of Pennsylvania, in connection with any such proceeding; (b) agrees that each such court shall be deemed to be a convenient forum; (c) agrees that service of process in any such proceeding may be made by giving notice pursuant to [NOTICE PROVISION SECTION]; and (d) agrees not to assert, by way of motion, as a defense or otherwise, in any such Proceeding commenced in any such court, any claim that such party is not subject personally to the jurisdiction of such court, that such Proceeding has been brought in an inconvenient forum, that the venue of such Proceeding is improper or that this Agreement or the subject matter of this Agreement may not be enforced in or by such court.”
Loan Document Clauses – Counterparts and Electronic Execution

• To permit execution of the agreement by several parties in different locations clause:

“This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together will constitute one and the same instrument. This Agreement may be executed by facsimile signature, e-mailed portable document format (“PDF”) signature, or original signature. Any facsimile signature or e-mailed PDF signature shall be deemed an original and have the same effect as an original. This document will not be binding on or constitute evidence of a contract among the parties until such time as a counterpart of this document has been executed by each Party and a copy thereof delivered to the other Parties to this Agreement.”
The Documents are Solid – Now Don’t Blow It

• Actions can speak louder than words – course of conduct might waive the written protections in the agreement
Common Sense Considerations – The Loan File

A well documented loan file is critical to avoiding lender liability claims:

- The Lender’s loan file should “tell the story” of the life of the loan because years later memories fade and borrower’s imaginations “run wild”

- Not only should oral communications with the borrower and/or guarantors be confirmed in writing by email or letter, a written memorandum should also be included in the Lender’s loan file with a copy of the email or letter which explains the context of the communications
DISCUSSION