

LENDER LIABILITY¹

The Claims They Are Going To Keep On Coming

In the 1980's lender liability claims and defenses made many a lawyer rich, left bankers befuddled and did little to advance the course of justice. Lender's liability is an umbrella term for a lender's actual or potential liability to its borrower or third parties for claims relating to a loan.

THEORIES OF LENDER LIABILITY

- Breach of Contract
- Bad Faith
- Breach of Fiduciary Duty
- Duress
- Fraud and Misrepresentation
- Negligent loan processing and/or administration
- Environmental Laws²

BREACH OF CONTRACT

The most commonly litigated lender liability claims seems to arise from claims of breach of contract.

A loan is a contract between the parties and the starting point for commercial loans is the loan commitment which is often the base line contract between the parties.³ Loan commitment must generally contain

- (1) The name of the parties;
- (2) The amount of the loan and interest rate;
- (3) The expiration date;
- (4) Any conditions precedent; and
- (5) Other basic terms of the loan.⁴

¹ This is an abridged version of a larger précis on the same topic. If you wish to read the entire paper, please request same through the KLNevada.com web site.

² There are other theories of lender's liability, e.g. Fraudulent Transfer, Anti-trust, Bank Secrecy Act, Anti-tying violations, RICO, etc., but a full explication of all possible theories would take longer than the amount of time presently available for such a discussion.

³ Most commercial loans start with a written Loan Commitment. That need not be so, but subject to the strictures of a given state's Statute of Frauds, an oral commitment to lend monies might not be enforceable. See NRS 111.220 precluding loan contracts that can not be performed within one year or are more than \$100,000 from a person engaged in the business of money lending. In some states the oral prohibition on lending monies is significantly lower.

⁴ To the extent that there are terms of the loan which are not set forth, the Court can "fill in the blanks" as long as it is comfortable with the basic terms and business transaction which the parties are trying to document and is comfortable that the parties have had a true meeting of the minds.

The loan commitment is important in that it is a road map for the transaction. To the extent that the lender deviates from that road map after the commitment has been accepted by the borrower or to the extent that the lender does not enforce the provisions of the loan commitment, then there arises the possibility for lender liability claims. For example, in the case of a condition of the loan documentation requiring quarterly audited financials which is never enforced until the regulators, in examining the loan, criticize the laxity of the enforcement. It would be difficult to “call” that loan if the debtor were otherwise in compliance because it had violated a non-material term of the loan which by the course of dealing of the parties had not previously been enforced.

Once the borrower and the lender agree on the terms of a loan and any condition precedents to that loan (e.g. a commitment fee being paid), a contract, is formed. If a party breaches that contract, the usual contract remedies apply. Lender liability is found when the lender breaches its promise to either extend financing or to continue financing in accordance with the terms of the loan documentation. Similarly, the lender could be liable for breach of any promise to forbear from the exercise of remedies otherwise available to it under the loan documents or for failing to honor previously agreed-upon loan modification terms.

FAILURE TO FUND. One common problem with respect to banks is whether or not the lender becomes liable for failure to fund a loan or to lend money until an enforceable written loan agreement of some form has been made.⁵ Usually, a defense of Statute of Frauds prevents recovery in this situation. However, theories of promissory estoppel or negligent misrepresentation provide a possible source of lender liability despite Statute of Frauds problems. If the borrower takes actions in reliance on an oral promise to make a loan which such actions in reliance are explainable by no logical reason other than that the oral agreement was made, then equity might well intervene to protect the borrower.⁶ To establish such a tort, the representation generally had to be:

- Made by the defendant in the ordinary course of his business
- The defendant knowingly supplied "false information" for the guidance of others in their business;
- The defendant did not exercise reasonable care or competence in retaining or communicating the information; and
- The plaintiff suffers pecuniary loss by justifiably relying upon the representation.

⁵ Courts have recognized oral commitments to make loans and the putative Borrower can recover lost profits. The issue is was there an enforceable oral agreement. Was there a meeting of the minds? Words of encouragement are not sufficient to make an oral agreement. There must be a meeting of the minds and all material terms agreed upon.

⁶ The remedy can go by many names, but is primarily a waiver situation predicated upon promissory estoppel.

GOOD FAITH AND FAIR DEALING

Perhaps the most talked-about theory of lender liability is the concept of good faith and fair dealing.⁷ Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.⁸ The covenant of good faith and fair dealing requires that neither party do anything to deprive the other of the benefits of the agreement. In the event of breach, general tort remedies⁹ might be available to the borrower.¹⁰ The obligation of good faith present in every contractual relation is not an invitation to the court to decide whether one party ought to have exercised the rights provided to it by agreement. Rather, it is an implied undertaking not to take opportunistic advantage of a borrower. When the contract is silent, the principles of good faith and fair dealing fill the interstitial gaps.

The objective standard of good faith is one of honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. To prevail, the borrower must present evidence that the lender acted in an arbitrary, capricious, or unreasonable manner that exceeded the borrower's justifiable expectations. For example, in what could be a classic case, the borrower and lender operated for years under a line of credit loan secured by a blocked account into which all revenues were deposited and credited against the loan balance, giving the lender total control over the borrower's cash flow. When the bank refused to advance additional funds, the borrower, unable to use the blocked account, collapsed. The court held that the lender must have a legitimate objective for cutting off funding and must give adequate notice of its decision. In a case such as this, the damages to be paid by the lender can be in the millions of dollars over and above the amount of the unpaid loan.

When the loan documents give the lender discretion, the covenant of good faith and fair dealing will be implied so that the lender must exercise that discretion reasonably and not arbitrarily and capriciously.¹¹ Bad faith, or the absence of good faith, will not be found if the lender acts in the manner authorized by the loan documents and if the circumstances justify the lender's action and the way such action was taken.

⁷ Although facially counterintuitive, there is no independent cause of action for breach of a covenant of good faith and fair dealing in the absence of a breach of the underlying contract.

⁸ [*State, University and Community College System v. Sutton*](#), 120 Nev. 972, 103 P.3d 8, 194 Ed. Law Rep. 707, Nev., December 28, 2004 (NO. 39568)

⁹ Tort remedies are generally not available for a commercial relationship. Tort remedies require a special relationship usually found in insurance or trust relationships. Nevada does recognize a contractual claim for breach of the covenant of good faith and fair dealing, however, in the absence of a breach of contract. See the line of cases styled *Hilton Hotel v. Lewis*, one of which is 107 Nev 226, 808 P.2d 919 (1991). These cases generally arise in situation in which the duty to perform on the part of the defendant did not arise but the plaintiff alleges that the defendant did something to frustrate the purpose of the contract, such as cause the condition precedent to fail.

¹⁰ However, reference should be had to the Supreme Court case of [*State, University and Community College System v. Sutton*](#), *Id.* wherein the court said that there was no liability for breach of the duty of good faith and fair dealing in the absence of a "special relationship".

¹¹ N.B. Although not uniform in application, there generally is not imposed a duty to negotiate in good faith to get to a contract. [*Quezada v. Loan Center of California, Inc.*](#) Slip Copy, 2008 WL 510024, E.D.Cal.,2008.

Generally, neither a course of dealing nor the implied obligation of good faith can modify the express terms of an agreement—at least as to material rights. There are some exceptions, however, and if, for example, the lender has historically accepted tardy performance, it generally cannot, without notice that it will henceforth insist upon timely performance, enforce its remedies upon the late performance of the borrower. The result may be the same even when the loan documents contain an anti-waiver clause. It is submitted that the degree of non-compliance that will be tolerated is in inverse relationship to the materiality of that non-compliance.

FIDUCIARY RELATIONSHIPS

A fiduciary relationship requires a “special” relationship between the parties. A lender/borrower relationship without more is not sufficient to establish a fiduciary relationship. The existence of a fiduciary relationship imposes special burdens on the lender over and beyond those to which it believed that it might have. It transforms what was intended to be an arms length relationship to one where the lender might have to make decisions in the best interest of its own borrower.

The theory is espoused in litigation as the first cousin of the duty of good faith and fair dealing. It is however a separate theory, but there is an inter-relationship between the two. In the minds of lender liability counsel, the doctrine of breach of a fiduciary relationship and breach of a duty of good faith and fair dealing are akin to a set of conjoined twins.

Factors which may give rise to a "special relationship" bestowing a fiduciary standard include:

- When one party is guided by the judgment or advice of the other party and is justified in believing that the other party will act in his interest;
- When one party has acquired influence over the other and has abused that influence;
- When the parties have consistently worked together toward a mutual goal;
- When the lender knows or has reason to know that the customer is placing his or her trust and confidence in the lender and is relying on the lender to counsel and inform;
- When both parties understand that a special trust or confidence has been reposed; and/or
- When there is an allegation of dependency by one party and a voluntary assumption of a duty by the other party to advise, counsel and protect the weaker party. Factors which may give rise to a "special relationship" include: When one party is guided by the judgment or advice of the other party or is factually justified in believing that the other party will act in his interest;

Modern commercial banking practices and the “know your customer rule”, may unwittingly position the lender into the role of an advisor, thereby creating a relationship of trust and confidence and a resulting fiduciary duty. To establish liability, there must be control by the

lender over the decision-making processes of the debtor. Accordingly, when the loan is going bad and the lender, with the best of intentions is exercising *de facto* control over the project, that well intentioned lender is marching itself into a lender's liability box.¹²

The existence of a fiduciary relationship may be shown when friendship, business relationships, or agency results in the lender gaining influence and superiority over the borrower. If the lender acts in an advisory role, such as advising a borrower to expand its business, or if the lender has acted as financial advisor to the borrower for years and the borrower has relied upon the lender's advice, it may have created the confidential relationship that helps to give rise to a fiduciary role and fiduciary obligations.

NEGLIGENT MISREPRESENTATION

To be liable for the tort of negligent misrepresentation, the offending representation had to be:

- Made by the lender in the ordinary course of his business;
- The defendant supplied "false information" for the guidance of the borrowers in their business;
- The lender did not exercise reasonable care or competence in retaining or communicating the information; and
- The plaintiff suffers pecuniary loss by justifiably relying upon the representation

FRAUD

A lender may become liable for fraud by misrepresenting a material fact or by making a promise with the intent not to perform that promise where a debtor reasonably relied on the representation to his or her detriment. To establish a claim of fraud, a plaintiff must show that:

- The lender made a material representation;
- The representation was false;
- The lender makes a statement of intent, e.g. commitment that the project will be completed when it has no intent to advance the funding to do so;¹³
- When the defendant made the representation, it knew it was false or made the representation recklessly without any knowledge or investigation of the statement's truth;
- The defendant intended that the plaintiff act upon the statement;
- The plaintiff acted in reliance upon the statement;
- The plaintiff suffered injury as a result of the lender's misrepresentation coupled with the borrower's reliance.

¹² See generally 42 Am Jur Trials §419 for a discussion of indicia of control and how far is too far.

¹³ A variance on the same theme would be negligent misrepresentation when the lender made the statement without a well founded belief in its accuracy. The practical difference between fraud and negligent misrepresentation is that the former is an open invitation to punitive damages although without more, a simple negligent misrepresentation will probably not support a punitive damage claim.

When a lender, as part of a scheme, makes a promise regarding a future event without the current intent to perform, the lender might very well be liable. For example, if a lender promises to make a loan to induce a borrower to take certain action, such as restructure a debt, after having already decided not to honor the commitment to make the loan and the borrower relies upon the promise, the lender may be liable.

ECONOMIC DURESS.

A lender may be liable under a claim of duress if the claimant can prove the requisite elements. The elements for a finding of duress are:

- A threat to do something that the threatening party has no legal right to do;
- The threat destroys the free agency of the party to whom it was directed and causes the party to do that which he or she would otherwise not do, and which he or she was not legally bound to do;
- The restraint caused by the threatening party must be imminent; and
- The person to whom the threat is directed has no present means of protection.

TORTIOUS INTERFERENCE WITH CONTRACT.

Generally, a borrower must prove four elements to maintain an action for tortious interference with a contractual or business relationship. The elements of a cause of action for tortious interference are:

- Existence of a contract subject to interference;
- That the act of interference was willful and not otherwise justified;
- That such intentional act was a proximate cause of plaintiff's damage; and
- Actual damage or loss occurred.

The tort of intentional interference with contract imposes liability only if a *third person*, without privilege to do so, is induced not to perform the contract. The plaintiff need not prove ill will, spite, evil motive, or intent to harm to recover for this tort. A general intent to interfere coupled with action is sufficient. Interference is wrongful if the act does not rest on a legitimate interest.

Intentional Interference With Business Expectancies

The elements of this tort are:

- A prospective contractual relation between the third party and the plaintiff;

- The purpose or intent to harm the plaintiff by preventing the relationship from occurring;
- The absence of privilege or justification on the part of the actor; and
- The occurrence of actual harm or damage to plaintiff as a result of the actor's conduct.

In a successful interference claim, the defendant will be liable for all reasonably foreseeable damages, that is, lost profits and other damages suffered by the plaintiff after the tort occurred.

The issue of interference with commercial contracts or expectancies not infrequently arise when a Banker is presented with a loan opportunity. It turns down the opportunity which is being shopped and is then subsequently presented with the same opportunity by a different and perhaps stronger putative borrower. The question presented is does the prospective lender have to “pass” on the deal or can it make the Loan? With strict adherence to the principles of fidelity, the shopped opportunity can be closed. However, the lender would be well served to adequately, accurately and extensively document the loan file as to the reasons for the initial declination and subsequent approval.¹⁴

NEGLIGENCE

There are a horde of cases which have as their primary claim of culpability that the lender knew or should have known that the proposed project did not “pencil out”, but the lender wanted its fees and origination points and did not stop the borrower from proceeding with the loan.

While claims such as this, if they get to the jury, have mixed results, the bottom line is that they should be able to be judicially adjudicated “on the papers” without having to expose the parties to the vagaries of the jury. In the case of the appraisal and any *pro formas* prepared by the borrower, the lender does not have an affirmative duty to tell the borrower whether it is a good or bad loan or whether the appraisal or *pro forma* does or does not support the loan. The borrower has a positive duty to protect itself and as long as it does not exercise duress and/or control over the borrower, the borrower is free to make a bad business decision. The lender is not the surety of the success of the project

WRONGFUL ACCELERATION.

Depending upon the language in the loan documents, the lenders' "wrongful acceleration" of a note may constitute a breach of contract. The right to accelerate is core to many loan work out or liquidation situations. It is to be assiduously guarded.

The bottom line to be drawn is to exercise care in making a precipitous change in the relationship between the borrower and the lender even if you, as the lender, have the contractual right to do so. Take great care before accelerating a loan where there is not a material event of default or the event of default is predicated upon a course of conduct which the lender has condoned.

¹⁴ See e.g. *Willow Funding v. Grencom Associates*, 245 Conn. 615, 717 A. 2d. 1211

CONTROL

Control is perhaps the key element in most successful lender liability litigation resolved in favor of borrowers. The key element is control over property or decisions of the borrower made in the presence of

- Actions taken in the context of unequal bargaining power
- Adhesive contract¹⁵
- Financial well being entrusted by the borrower to the lender
- Reasonable expectation of reliance by the borrower on statements made and/or actions undertaken by the lender.
- Domination over borrower's will.

A fiduciary relationship occurs when trust and confidence are coupled with domination and superiority. If established, then the lender must put the borrower's interest at least on a par with if not above its own. In the immortal and often cited words of Justice Cardozo, the duty owed is the punctillo of an honor, the most sensitive and this standard of honor and code of conduct is inveterate and unbending.¹⁶

As unbending as the code of conduct when a fiduciary relationship is established, the normal banking/borrower relationship itself--standing alone--does not establish a confidential relationship. *Giles v. General Motors Acceptance Corp.*, 494 F.3d 865, C.A.9 (Nev.), 2007.¹⁷ The lender merely asking for advice does not establish a fiduciary relationship. However, in the normal marketing of a lender's products there might be uttered comments, advice and suggestions that transmogrify the arm's length relationship into a fiduciary relationship. This is, indeed, the interface between marketing and legal obligations.

Closely related to theories of direct or joint venture/partnership liability is the theory that the lender is liable to the borrower and third parties because of the control it exercises over the borrower's day-to-day operations. A lender exposes itself to liability to the borrower and potentially to third parties if it exercises undue control over the borrower. Also, when a lender controls the borrower's assets, stock, and cash management, a fiduciary relationship can be created between the borrower and the lender that exposes the lender to liability both to the borrower and to third parties. One of the few cases in Nevada addressing the issue of lender liability is *Davis v. Nevada Nat. Bank*, 103 Nev. 220 (1987), which discusses lender liability for construction loans.¹⁸ The case held that lender liability may arise under a construction loan

¹⁵ A contract of adhesion is generally a contract offered on a "take it or leave it" basis with no real opportunity to negotiate. Although generally referred to in the context of consumer contracts, it is not limited to consumer protection. See *Kindred v. Second Judicial Dist. Court ex rel. County of Clark*, 116 Nev. 405, 996 P.2d 903 Nev., 2000

¹⁶ *Meinhard. v. Salmon*, 249 N.Y. 458, 464 (1928)

¹⁷ There is interesting language in the *Giles* case that, in the absence of a fiduciary relationship, claims for constructive fraud and/or undue influence would fail.

¹⁸ Another case is *Countrywide Homes v. Thitcheve*, 192 P. 3d 243 where a bank had to pay significant damages as a result of foreclosing on the wrong home. In the author's opinion, this case more closely resembles a simple negligence case than it does the traditional lender's liability claim.

when: (1) the lender assumes the responsibility or the right to distribute loan proceeds to parties other than its borrower during the course of construction; (2) the lender is apprised by its borrower of substantial deficiencies in construction that affect the structural integrity of the building; (3) the borrower requests that the lender withhold further distributions of loan proceeds pending the satisfactory resolution of the construction deficiency; (4) the lender continues to distribute loan proceeds in complete disregard of its borrower's complaints without any bona fide attempt to ascertain the truth of said complaints; and (5) the borrower ultimately was damaged because the substance of the borrower's complaints was accurate and the borrower was unable to recover damages against the contractor or other party directly responsible for the construction deficiencies.¹⁹ While the facts in *Davis, Id.* are virtually *suis generis*, the principles of the case are well worth remembering. How far *Davis* will be expanded is a matter of conjecture, but better to be forewarned about the possible consequences of falling into the control trap.

CONSTRUCTION PROJECT FINANCING AND LENDER LIABILITY

Because the relationship between the lender and the borrower is more tightly intertwined in a construction loan situation, the circumstances are more susceptible to lender liability claims.

The law does not impose on the construction lender the duty to inspect, although that duty is a right generally bargained for in the Loan Documents. The Loan documents should almost always, for reasons of practicality, allow for the duty to inspect, but should also negate any duty to inspect for the borrower's or any third party's benefit. The right to inspect is not a duty and it is the prerogative of and for the sole benefit of the lender. If the right/duty to inspect is not so limited then the borrower has a claim that the inspection was intended to be for its benefit and thus anything not found, discovered or vetted would theoretically be for the account of the lender if the borrower relies on the lender's inspections.

Related to the duty to inspect is the question of disbursement. If a lender were, either pursuant to the documents or a course of practice, to disburse directly to the tradesmen and materialmen, then there is a higher degree of care. As the Nevada Supreme Court has held, lender's liability for disbursement of funds may arise under a construction loan when the lender assumes the responsibility or the right to distribute loan proceeds *Davis v. Nevada Nat. Bank*, 103 Nev. 220, 737 P.2d 503, Nev., May 27, 1987.

There is no duty to and the lender/borrower relationship does not establish any duty to insure the financial viability of the project for the benefit of subcontractors. However, once the

¹⁹ Notwithstanding *Davis*, it should be noted that N.R.S. 41.590 states "A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property, shall not be held liable to the borrower or to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacture, construction, repair, modification or improvement of such real or personal property, unless the loss or damage is the result of some other action or activity of the lender than the loan transaction."

lender confirms to subcontractors that money is available to do work then the lender can have liability if it stops funding without good faith and good basis.²⁰

MINIMIZING LIABILITY

Minimizing risk is a legitimate goal of a commercial lender. While it can be done, it is important that it be done “up front” and fully disclosed. Documents which give the lender shared control of the venture or have split profit formula for loan repayment or perhaps even “equity kickers” while perhaps attractive in the short term could conceivably, if a wide enough net were cast, have devastating effects over the long term.

Lenders should be wary of arrangements with borrowers that could constitute joint ventures. Loan documents should expressly negate any partnership, joint venture, agency, or relationship other than lender and borrower. If a joint venture is desired, make certain that the loan analysts and draft persons appreciate that their work may be subject to close scrutiny by the ultimate purchaser to whom additional duties might have arisen as a result of an agreement with the indicia of a joint venture.

Insure that loan agreements contain unambiguous exculpatory language making it clear that the lender's inspection and monitoring activities are for the lender's exclusive benefit. This language should perhaps be incorporated into recordable loan documents to put third parties and potential purchasers on notice of this limitation on the lender's obligation. The documents should provide that the lender, by making loan disbursements after inspections, does not make any warranty or owe any duty for the benefit of the borrower or third parties as to the quality of the construction inspected.

In a foreclosure, exercise extreme care when deciding whether and to what extent to complete a project. A lender that completes defective construction may become liable for failing to cure the defect. Further, contracts of sale for foreclosed improved property should contain appropriate disclaimers or limitations of warranty to limit the lender's liability for unknown defects occurring prior to foreclosure.

ANSWER TO LENDER LIABILITY CONCERNS

There is no way to absolutely prevent lender liability exposure. The surest place to start is to make certain that your package of loan documentation is complete and not so draconian as to strip the borrower of certain indicia of control necessary to avoid having the borrowing relationship characterized as a joint venture or partnership. If the borrower is not doing what it should be doing or is doing what it should not be doing, even if on a nonmaterial covenant, the non-performance should be documented and the documentation of deficiency circulated to the borrower. As the project proceeds, document, document and document again not only changes made in the relationship, but the reasons for such changes. If the borrower is not doing what it should be doing or is doing what it should not be doing, even if on a nonmaterial covenant, the

²⁰ It is vital that the project documents clearly specify that the potential mechanic lienors are not third party beneficiaries of the finance documents between the lender and the borrower.

non-performance should be documented and the documentation of deficiency circulated to the borrower.

It is worth repeating, a word of advice to the wary is to make sure that your loan documents are in proper form, document all actions taken and/or conversations where the borrower is making requests to vary the terms of the loans

CONCLUSION

While not subject to empiric proof, it is believed that the incidence of lender liability litigation is inversely proportional to the availability of credit. The easier it is to “buy” replacement dollars, the less need there is for the borrower to commit resources to the uncertain world of lender liability litigation. Unfortunately, when the loan reaches the point that fingers are pointing and lender liability is being asserted, the relationship between the borrower and lender has frequently deteriorated to the point that the court house steps are the only forum where any useful non didactic dialogue takes place between the parties.