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Lender Liability: Evaluating, Minimizing and Defending Claims

Defending Against Attacks on Loans in Workout, Default and Bankruptcy

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

W. Mike Baggett, Chairman Emeritus, **Winstead**, Dallas
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Mark J. Kalla, Partner, **Dorsey & Whitney**, Minneapolis

Tuesday, March 16, 2010

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12 pm Central

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Lender Liability: Evaluating, Minimizing and Defending Claims Contract Liability

Mark Kalla, Partner, Dorsey & Whitney LLP,
with the assistance of Elizabeth Temple,
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Overview

- Is there a unified theory of “Lender Liability”?
- Contract and Quasi-contract
- Tort
- Statute
- Other Common Law

Contract Claims

- The lending relationship is a contract relationship that can subject the lender to claims for breach of any of the written terms of a contract.
 - This applies not only to the final executed loan agreement, but to commitment letters and other documents evidencing the intent of the parties to create a binding commitment.
 - The breach of contract action can also apply to oral or imputed agreements.

Covenant of Good Faith and Fair Dealing

- The Uniform Commercial Code specifically imposes an obligation of good faith in the performance and enforcement of contracts. UCC § 1-304.
- Separate from the UCC statutory obligation, courts read an implied duty of good faith and fair dealing into every contract. *E.g.*, *Van Gemert v. Boeing Co.*, 553 F.2d 812, 815 (2d Cir. 1977).
 - Courts disagree as to whether it breaches the duty of good faith and fair dealing to alter a course of conduct, even if that course of conduct was inconsistent with the contract's written terms.
 - Compare *Schaller v. Marine Nat'l Bank of Neenah*, 388 N.W.2d 645 (Wis. Ct. App. 1986) (holding that obligation to act in good faith did not require bank to continue honoring overdrafts, even after doing so 36 times)
 - with *Kendal Yacht Corp. v. United Cal. Bank*, 123 Cal. Rptr. 848 (Cal. Ct. App. 1975) (holding bank liable for not honoring overdrafts after encouraging borrower to believe that overdrafts would be honored)

Credit Agreements

- Breach of Express Covenants
 - Normal breach-of-contract rules apply.
- Breach of Commitment Letter
 - Generally the lender has no obligation to make a loan, or to protect an inexperienced borrower.
 - The development of a special relationship, however, may give rise to such duties.
 - Lender must use reasonable care in the application process and must comply with laws regarding discrimination, redlining, etc.
- Letters of Intent
 - Though letters of intent to make a loan may expressly disclaim their status as a commitment, care should be taken that they not express a binding intent.
 - See *Teachers Ins. & Annuity Assoc. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987) (identifying five factors with which to determine whether parties intended to be bound: (1) the language in the agreement; (2) the context of negotiations; (3) the existence of open terms; (4) partial performance; and (5) whether it was customary in the relevant marketplace to put the agreement in a final form).

Credit Agreements

- Oral Agreements or Amendments
 - Contracts may and should provide that they cannot be changed except by an express written agreement.
 - Notwithstanding such provision, contracts may be changed or supplemented by oral agreements between the parties.
- Course of Dealing—review loan files, correspondence, officer comments, and email.
- Clear Channel case has raised the possibility that a court could award specific performance of a commitment letter. *BT Triple Crown Merger Co. v. Citigroup Global Markets Inc.*, 2008 N.Y. Misc. LEXIS 2682, at *2 (N.Y. Super. Ct. May 7, 2008).

Demand Notes

- Wording and tenor of demand note may provide false protection to the lender.
 - Some courts have refused to enforce the terms of a demand note and have imposed an extra notice obligation on the lender.
 - *Reid v. Key Bank of S. Me., Inc.*, 821 F.2d 9 (1st Cir. 1987).
 - But see *Pavco Industries Inc. v. First National Bank*, 534 So. 2d 572 (Ala. 1988) (holding that implied duty of good faith did not apply to demand note); *Larson v. Vermillion State Bank*, 567 N.W.2d 721, 724 (Minn. Ct. App. 1997) (“Minnesota law does not subject a lender to a duty of good faith, separate from the express terms of a loan agreement, in calling due a demand note.”).
 - See also *Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990) (“[P]rinciples of good faith . . . do not block use of terms that actually appear in the contract.”).

Insecurity Clauses

- Not very helpful as an after-the-fact justification for improper acceleration.
- An insecurity clause provides that a secured lender may accelerate indebtedness when it deems itself insecure.
- Such clauses are enforceable only if the lender “in good faith believes that the prospect of payment or performance is impaired.” UCC § 1-208.
- Demand note should be drafted with clear language and no wiggle room.
- Loan and security agreement cannot cover all circumstances for all borrowers, so insecurity clause may be necessary.
- Enforceability of such clause not without litigation costs.
 - See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760-63 (6th Cir. 1985) (affirming jury verdict that lender breached the duty of good faith and fair dealing by, without notice, refusing to advance funds under a line of credit relying on an insecurity clause).

Material Adverse Change and Material Adverse Effect Clauses

- Is the change material?
- Does the loan agreement require lender to reasonably forbear?
- Did lender suggest that it never enforced or wouldn't enforce such clause?
- Was the “adverse change” in existence or reasonably foreseeable at the outset of the loan?
- Negotiations concerning MAC or MAE clauses can be important in their enforcement.

Acceleration Clauses

- Acceleration cannot be based upon waived defaults.
- Lender must adhere to conditions precedent for acceleration.
 - Adequate notice
 - Opportunity to cure

Discretionary Advance Clauses

- May not be completely discretionary
- May be tempered by course of dealing and other communications between parties

Construction Loan Agreements

- Construction Defects
 - A lender is typically not liable for construction defects.
 - However, where lender's relationship with developer depended upon purchasers financing with lender, lender was found to have such duty. Connor v. Great Western Savings & Loan Association, 69 Cal. 2d 850, 447 P. 2d 609 (1968).
- Duty to Inspect
 - Typically no such duty exists, but construction lenders, who often inspect for own purposes, should make sure to disclaim any such duty for benefit of the Borrower.
 - Disbursements
 - Case law has created significant obligations upon a lender who has contracted to make disbursements under a construction loan agreement. Davis v. Nevada State Bank, 103 Nev. 220, 737 P. 2d 503 (1987).

Damages

Compare Contract & Tort Damages

- Generally, Lender Liability actions based upon Contracts are limited to the terms of the contract and consequential damages.

TORT THEORIES OF LIABILITY – DIVIDING LINE BETWEEN CONTRACT AND TORT - CONTORTS

**W. Mike Baggett
March 16, 2010
Dallas, Texas**

Fraud and Misrepresentation

- Elements of Fraud
 - That a material representation was made
 - That it was false
 - That, when the speaker made it, he knew it was false or made it recklessly without any knowledge of its truth and as a positive assertion
 - That he made it with the intention that it should be acted upon by the party
 - That the party acted in reliance upon it
 - That he thereby suffered injury

Fraud and Misrepresentation, contd.

- Representation Must Be of Material Fact – Not an Opinion, Judgment, Probability or Expectation
- Reasonable Reliance
- Party Executing Documents Charged With Knowledge of Contents
- Promise to Act in the Future Not Actionable Unless No Present Intent to Perform
- Promise to Do a Criminal Act
- Conditional Promise Not Actionable Unless Condition Satisfied
- Authority of Party Making Representation

Fraud and Misrepresentation, contd.

- Parol Evidence Exclusion of Oral Representations That Vary or Contradict the Terms of a Written Agreement
- Course of Dealing Will Not Vary or Contradict Written Agreement
- Custom and Usage Will Not Provide New Terms for a Contract
- Statute of Frauds to Restrict Enforcement of Oral Commitments for Loan in Excess of \$50,000.00

Duress

- Elements of Duress
 - There is a threat to do something which a party threatening has no legal right to do
 - There is some illegal exaction or some fraud or deception
 - The restraint is imminent and such as to destroy free agency without present means of protection
- Economic Duress Only Where Threatening Party was Responsible for Claimant's Financial Condition
- Duress Only Where Threatening Party Has No Legal Right to Take Threatened Action
- Statement of Legal Opinion Where Recipient Had Access to Legal Counsel Is Not Duress

Intentional Interference with Contractual Relations

- Elements of a Cause of Action for Tortious Interference
 - Existence of a contract subject to interference
 - That the act of interference was willful and intentional
 - That such intentional act was a proximate cause of plaintiff's damage
 - Actual damage or loss occurred

Breach of Fiduciary Duty / Good Faith and Fair Dealing

- UCC Section 1-203 Duty of Good Faith – Good Faith In Fact
- Good Faith and Fair Dealing Will Not Impose a Duty Contrary to Express Contract Terms
- The Relationship Between Mortgagee and Mortgagor Does Not Give Rise to a Duty of Good Faith and Fair Dealing.
- *FDIC v. Coleman*, 795 S.W.2d 706 (Tex. 1990)

Statute of Fraud / Loan of Money Must Be in Writing and Executed to Be Enforced

Damages – Contract or Tort – Benefit of Bargain Damages Only In Contract Case (Lost Profits)



TORT THEORIES OF LIABILITY – DIVIDING LINE BETWEEN CONTRACT AND TORT CONTRACT

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Lender Liability: Evaluating, Minimizing and Defending Claims

Best Practices to Minimize Lender Liability Claims

Before A Claim Is Made

- Train Your Client – “An Ounce of Prevention...”

Review Loan Documents for Latest Protective Language

“Thou shall take no precipitous action”

Document, Document, Document

Keep It Clean

Expect to read everything you put in the file out loud in a courtroom

After A Claim Is Made

- Statute of Frauds

- Arbitration Clauses

Retracting existing financing

- What is the basis for retracting financing?
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- Beware of Dragnet or Big MAC clauses
 - “Thou shall take no precipitous action”

Loan workouts

- State clearly what you expect from the other side in writing
- Include a waiver of lender liability claims to the date of modification

Foreclosures

- Always liquidate personalty before realty
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- Make sure liquidation sales are adequately advertised
 - Credit Bids should reasonably approximate current fair market value

Bankruptcy considerations

- Theory of Deepening Insolvency
-
- Preference Payments

Multi-lender considerations

- Mutual Account (Split Borrowing)?

-
- Participation Loan?

Make sure participation agreements include provisions for a default of Lead Lender

Indemnity for Lender Liability