

INSIGHTS + NEWS

Client Alert: Lender Liability During COVID-19

BY CESIRA NEWCOMB • APRIL 29, 2020

During an interview with Bloomberg TV on March 6th, Lawrence Summers, former Secretary of the U.S. Treasury, observed: “Economic time has stopped but financial time has not stopped.” An incisive summary as any of the current predicament facing debtors and creditors. Strapped for cash and finding themselves in loan default, many borrowers are asking their lenders to forbear, or extend further credit, and often both. Lenders want to do the right thing, while maintaining flexibility and insulating themselves from further risk. What to do?

In the context of working out distressed loans, lenders may become more involved in the business operations of their borrowers. A lender’s agreement to forbear from exercising remedies will require the borrower to meet operational and transactional milestones. As lenders mull restructuring proposals and decide whether to act (or refrain from acting), they should be mindful of potential lender liability. Lender liability refers to a body of case law where a lender is found liable for losses sustained by a borrower or a third party that directly or indirectly flow from the lender’s actions in connection with a loan.

Lender liability theories can be divided into two categories: contract-based claims (typically brought by the borrower) and tort-based claims (typically brought by the borrower’s creditors). In general, lender liability lives and dies by the amount of control the lender has managed to exert over the borrower and the sufficiency and independence of the borrower’s management during work-out negotiations. Some of the more common lender liability theories are discussed below.

BREACH OF CONTRACT

The relationship between a lender and a borrower is contractual. The lender promises to extend credit to the borrower in accordance with the terms of the loan documents in exchange for the borrower’s promise to repay. These promises can be ongoing, as in the case of a revolving line of credit where the borrower repeatedly borrows money to cover operational costs. A lender can freeze the credit line if an event of default has occurred. The borrower might dispute that a default has occurred and accuse the lender of breaching the agreement by refusing to release funds.

When disputes of this nature reach the courts, judges may consider whether the parties’ course of dealing has deviated from the strictures of the loan agreement. In some cases, the Lender might be estopped from demanding strict compliance with the loan agreement on account of its earlier tolerance of technical defaults. Damages for a lender’s breach of contract are usually limited to compensatory damages, such as the additional costs of obtaining funding from another source.

BREACH OF IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Under Massachusetts law, every contract is subject to an implied covenant of “good faith and fair dealing.” Courts read this requirement into commercial agreements to ensure that the parties remain faithful to the expectations of the contract. In addition, the Uniform Commercial Code – which covers secured lending transactions – imposes an obligation of good faith in the performance and enforcement of contracts.

In the lender-borrower context, this implied covenant requires the lender to be honest in its dealings and not purposefully injure the borrower’s right to obtain the benefit of the contract. It should be noted, however, that good faith and fair dealing do not prevent the lender from engaging in “hard-nosed” negotiations with the borrower following an event of default.

NEGLIGENCE AND BREACH OF FIDUCIARY DUTIES

A lender does not generally owe a duty of care to a borrower. Lender-borrower business relationships tend to be conducted at an arms-length and, without more, Massachusetts courts will not find a fiduciary relationship. In rare instances, however, a lender may exercise control over the borrower’s business to such an extent that a court may find a fiduciary relationship to exist. It is not uncommon for lenders to receive confidential financial information pertaining to the borrower’s business or to refuse to fund projects or acquisitions. This level of access and participation is probably insufficient to establish fiduciary duties. Once the lender begins to direct the borrower’s day-to-day operations, however, the perception of control and attendant fiduciary duties become more pronounced.

FRAUD/MISREPRESENTATION

A lender might be liable for fraud if it makes a material, false misrepresentation with knowledge of its falsity upon which the borrower reasonably relies to its detriment. A fraud finding can result in liability for both actual and punitive damages. In the context of working out a commercial loan, it is conceivable that a lender might make a promise to the borrower (to forbear, for example), that the borrower might later claim was a false misrepresentation. Some jurisdictions have effectively barred this argument by enacting “statutes of frauds” which prohibit lawsuits on credit agreements (including the promise to lend or forbear) that are not reduced to a writing. If, however, the borrower takes action based on an oral promise to forbear, or perhaps an emailed exchange promising the same, by making a payment for example, such conduct might prevent the lender from relying on the statute of frauds as a defense to a subsequent fraud claim.

ECONOMIC DURESS

A borrower might sue a lender for economic duress where a lender coerces the borrower into involuntarily accepting terms when the borrower has little choice other than to comply with the lender’s demands. Because lenders often possess significant leverage in any work-out situation, it is foreseeable that a borrower would later seek to blame the lender for forcing it into a value-destroying deal. Duress is, first and foremost, an affirmative defense that a borrower asserts in response to a lender’s claims for damages arising from its borrower’s default of its obligations. It is unclear whether Massachusetts courts would recognize duress as a tort upon which a borrower could recover damages.

Lenders who drive a hard bargain during times of economic distress should nevertheless beware the specter of the fraudulent transfer. Under state and federal bankruptcy law, a transfer made by an insolvent borrower may be undone (or “clawed back”) if the borrower did not receive reasonably equivalent value in exchange for concessions made to the lender. The term “transfer” includes collateral that a borrower has granted while in default, or third party pledges and guarantees provided by the borrower’s affiliates.

LIABILITY TO THIRD PARTIES: THE INSTRUMENTALITY THEORY

The law generally protects commercial lenders from liability for the debts of their borrowers. As discussed above, an exception may apply in rare circumstances when the lender becomes overly involved in the borrower's daily operations and exerts its financial leverage to the extent that management can no longer reach independent decisions. The "instrumentality theory" says that a lender is liable for the debts of the borrower when it exerts such a degree of control over the borrower that the borrower becomes a mere business conduit for the lender.

The instrumentality theory is similar to the equitable remedy of piercing the corporate veil to permit creditors of one entity to seek satisfaction from a separate entity. The lender's control of the borrower must be total and unmistakable. The customary "control" that lenders exert over borrowers by making advances and reducing funding in accordance with the terms of their loan agreements is not sufficient. Creative creditors might still argue that a lender with less than total control over a borrower's business is nevertheless in some form of principal/agent or joint venture with the borrower. Such theories are uncommon, but there is precedent in case law.

TORTIOUS INTERFERENCE WITH A CONTRACT

An aggrieved party might approach the same "lender-in-control" theory from a slightly different angle by accusing the lender of tortiously interfering with its contractual relationship with the borrower. To do so, the party must show (1) a contract with the borrower, (2) that the lender knowingly induced the borrower to break that contract, (3) that the lender's interference was intentional and improper in motive or means, and (4) that the party was harmed by the lender's actions. Courts interpreting the "knowing inducement" element of this claim require that the lender provided "substantial assistance" to the borrower by affirmatively assisting in the breach or helping to conceal or failing to act in a manner that allows the breach to occur. Courts generally hold that a lender has no affirmative duty to protect other creditors or consider the interests of anyone other than itself. In other words, it is not improper for lenders to pursue their own economic interest. A demand for repayment of a bona fide debt is not a corrupt inducement that would create lender liability.

UNFAIR AND DECEPTIVE TRADE PRACTICES

In 1967, the Massachusetts legislature enacted a consumer protection statute, which is commonly known as "chapter 93A," referring to its location in the General Laws. A 1972 amendment gives businesses harmed by "unfair method[s] of competition or an unfair or deceptive act or practice" a claim for actual damages, which may be trebled if the court finds that the defendant's conduct was in willful or knowing violation of the statute. Businesses seeking relief under chapter 93A are held to a stricter standard than consumers in terms of what constitutes unfair or deceptive conduct. Courts have held that chapter 93A is intended "exclusively for egregious conduct." Nevertheless, even in vigorous competition among business concerns, misrepresentations may be so seriously deceptive and harmful as to permit some recovery for the injury really caused by them. Indeed, in some circumstances, even half-truths may constitute serious deception.

CONCLUSION

The possibility of lender liability increases when the lender departs from a course of dealing under the loan documents or exerts significant control over the borrower's operations following a loan default. Lenders can take comfort in the fact that it is not easy for a plaintiff to prove lender liability based on typical work-out activity. Nevertheless, these claims are costly to litigate and resolve. In addition to damages liability, lenders who acquire additional security during a work-out in the form of new collateral or guarantees from the borrower or third parties must understand the risk that such transfers might be later challenged as constructively fraudulent if the borrower parties do not receive adequate value in return.

For lenders, the best defense against lender liability is to engage counsel early in a work-out situation and take care to

document communications with the borrower in writing. If the lender's course of dealing has strayed from the loan documents, the lender should clearly communicate to the borrower that strict compliance with the loan agreement is required going forward. Finally, the lender should welcome the presence of professionals on the borrower's side. Not only can restructuring counsel or turnaround management assist the process, but their very presence ensures arms-length negotiations and can neutralize allegations of lender dominance.