

BUYING TROUBLE

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LENDER LIABILITY

What is Lender Liability?

In the world of commercial banking, lender liability refers to a legal doctrine which holds banks liable for a borrower's financial losses that are caused, directly or indirectly, by the bank's actions or inactions.

- Breaching a contract
- Negligently or fraudulently responding to credit inquiries about customers
- Negligently processing and administering a loan
- Making loans in bad faith
- Failing to fund loans and declining to renew loan facilities after orally promising to do so
- Improperly foreclosing on loans without giving appropriate notice
- Meddling in the day-to-day management of the borrower and taking a commanding role in a borrower's business to its ultimate detriment
- Aiding and abetting improper conduct by a borrower

What are the Consequences of Lender Liability?

Damages awarded in a lender liability lawsuit are not limited to actual damages. Rather, where a court finds that a lender acted in bad faith by deliberately and willfully engaging in wrongdoing, the lender may be subject to punitive damages that could greatly exceed the amount of actual damages. Further, the vast majority of cases involving lender liability issues are heard and decided by juries, meaning there is a possibility for very large verdicts.

The Ten Commandments for Avoiding Lender Liability

1. Do Not Make a Sudden Move:

Lenders should be careful not to act precipitously and without knowledge of all the facts surrounding a deal. For example, lenders cannot call a loan without notice or refuse to continue a long-term financing relationship, even if there are provisions for this in the loan document. The key is for lenders to always provide advance notice to their borrowers before taking action. Also, be very cautious in accelerating loans based on non-monetary defaults.

2. Always Tell the Truth:

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Being truthful will help ensure that you maintain your credibility and your word. For example, never lie in answering a credit inquiry about a borrower who does not have good credit. Also, never disclose information obtained in confidence, never misrepresent facts, and never threaten or promise to take action on a loan that you do not intend to carry out.

3. Practice Good Record-keeping and Communication with Borrowers:

Lenders should write all memos, credit underwriting packages, and other documents with the view that they may someday be read to a judge or a jury. Therefore all documents should be objective, unemotional, and accurate. It would be tragic for the borrower's counsel to discover documents in the lender's files that create an image before the jury that the lender is callous or calculating with regard to the borrower's interests.

Also, lending officers must document files carefully, ensure that all documents signed by the borrower fit the deal, and never make oral side agreements or have a borrower sign any agreement based on a prior oral statement. Finally, lending officers should carefully explain deals to borrowers in their entirety and before witnesses to ensure all parties are on equal playing fields.

4. Honor Your Commitments:

This one is simple — once a commitment for financing has been given, a lender cannot refuse to honor that commitment. Honoring your commitments will help guarantee that you maintain a good reputation and a solid client base.

5. Never Run a Borrower's Business:

A lender should not get involved in the management of a borrower's business. It is best to stay out of day-to-day business operations and avoid controlling possession of a borrower's assets, apart from having liens thereon.

6. When Loan Problems Arise, Turn to the Professionals:

Once a loan goes into default, loan officers should transfer the account to a workout officer. Further, workout officers should confer with outside counsel who specialize in handling workouts and fully understand the issues and risks of litigating with a borrower.

7. Put the Borrower in the Driver's Seat:

Borrowers frequently rely on the financial guidance and direction of their lenders. Thus, it is important to always inform the borrower that it is in control and that it is not required to agree to a change in the underlying agreements. This is particularly important to avoid duress claims. For example, suppose that a borrower is in default under the loan agreement. The likelihood that the borrower will fail to repay the loan has increased, while the likelihood that the borrower will find alternative financing sources has decreased. Here, the lender may threaten to foreclose or call the loan unless the borrower agrees to a substantially higher interest rate. As a result, the borrower may claim that it had no real choice but to accept the new terms. The borrower's vulnerable position may give rise to a duress claim. To avoid such situations, it is best to anticipate this possibility and provide for a higher interest rate in the original loan agreement. Above all, make sure that the borrower is aware of all options and makes its own decisions absent any pressure.

8. Be Careful About Accepting Late Payments:

Lenders should avoid falling into bad habits, one of which is consistently accepting late payments. Loan agreements normally include provisions stating that any failure to make a payment when due is a

default that entitles the bank to terminate the line of credit, or accelerate the due date of any future repayment obligation. Sometimes loan officers graciously accept payments after the deadline. Waiving a due date can be problematic when enforcing subsequent deadlines, as borrowers may rely on the waiver as an indication that they can be late with future payments. Thus, be clear about deadlines to avoid misleading a borrower. If you do make an exception, be sure to let the borrower know that the normal payment schedule will be enforced in the future.

9. Know Where to Draw the Line with Borrowers:

Over time, a non-contractual fiduciary relationship may develop between a lender and a borrower. When this happens, the borrower may increasingly rely on the lender's expertise and guidance in making financial decisions. Although the borrower may justifiably have a high level of trust and confidence in the lender, it is imperative that the lender maintain a certain level of objectivity and distance. The reason being, if the lender makes several poor decisions for the borrower, it may be subject to a breach of fiduciary duty claim. Thus, lenders should advise their clients but allow them make their own decisions.

10. Be a Professional and Treat your Clients Well:

Loan officers must abide by the rules of fair dealing. Specifically, be informative, honest and reasonable with the borrower. Never impose unreasonable time restrictions on a borrower. Rather, anticipate your clients needs, plan ahead and begin any loan process early.

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