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Ryan, Swanson & Cleveland, PLLC
1201 Third Avenue, Suite 3400
Seattle, WA 98101-3034

www.ryanswansonlaw.com

10 Commandments for Avoiding Lender Liability

By John R. Ruhl

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Introduction

“Lender liability” is a broad term that refers to various legal theories used by borrowers in lawsuits against lenders in connection with loans and loan commitments. The term is rooted in the notion that lenders must treat their borrowers fairly. It is defined by AmericanBanker.com as:

An informal term referring to various manifestations of actual or potential legal liability arising from the conduct of a financial institution lender. Generally, lender liability arises from allegations that a lender has violated a duty (whether contractual or implied) of good faith and fair dealing owed to the borrower or has assumed a degree of control over the borrower resulting in the creation of a fiduciary duty owed to the borrower or its other creditors or its shareholders.

This general definition is an umbrella for numerous types of legal claims that can arise at any point during the relationship between a lender and its customer. Such claims include:

- wrongfully refusing to honor a loan commitment;
- wrongfully refusing to honor an alleged “side deal” that is not clearly spelled out in the loan agreement;
- wrongfully failing to fund a loan;
- wrongfully refusing to renew a loan;
- negligently processing or administering a loan;
- misrepresenting information about a borrower in responding to credit inquiries;
- threatening to take enforcement action which the lender does not intend to carry out, but which causes the borrower to act to its detriment;
- improperly foreclosing a deed of trust or a mortgage or a security agreement without giving the required notice or otherwise following proper statutory procedures;
- selling a borrower’s collateral for less than its fair market value;
- interfering, to the borrower’s detriment, with a borrower’s day-to-day management or the borrower’s contractual relations with third parties;
- breaching a fiduciary duty that may have arisen or that a lender may have assumed (whether purposely or inadvertently) with respect to a borrower; and
- Other acts or failures to act that may be determined to constitute a breach of the lender’s duty of good faith to a borrower in carrying out the terms of the parties’ loan contract.



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Damages in lender-liability cases can be severe. Even though exemplary (or “punitive”) damages generally cannot be recovered in connection with most Washington state law claims, some claims filed pursuant to certain federal statutes can expose a lender to liability for treble damages or other amounts in excess of a borrower’s actual damages.

Unfortunately, juries may be likely to empathize with borrowers rather than with lenders. A jury can be expected to return a large verdict in favor of a borrower if the jurors conclude that the lender’s dealings with the borrower were egregious.

Given that human nature influences both borrowers and lenders in their dealings with one another, there is no fail-safe way to avoid lender-liability claims, especially in these challenging economic times – despite the comprehensive boilerplate lender-oriented loan documents generated by computer software, and despite the best-intentioned efforts of both lenders and borrowers and their respective counsel.

10 Commandments

Below are several practical guidelines that can be helpful to lenders in resolving problem loans successfully and avoiding or reducing the risk of lender liability¹. They are seemingly simple principles, but they can be difficult to remember and apply in the complicated customer situations faced every day by loan officers and special credit officers.

1. Thou Shalt Not Make a Sudden Move

Be careful not to act precipitously. This is a cardinal rule. Give as much advance notice to the borrower as possible under the particular circumstances, even if provisions in the loan documents literally permit the bank to act without notice.

For example, unless absolutely necessary to protect the bank’s interest, be very cautious in accelerating loans based on an “insecurity clause” in the loan documents, or in declaring a default based on any other non-monetary default provisions. Such actions can trigger claims which, even if successfully defended, can be quite costly to defend.

Additionally, whenever reasonably possible, give the borrower an adequate opportunity to obtain replacement financing, especially if the bank is adequately collateralized. Terminating the borrower’s financing without notice, even if allowed by the loan documents, usually is not necessary to protect the bank’s interest.

2. Thou Shalt Honor Thy Commitments

Once a written commitment for financing has been given, do not refuse to honor the commitment unless the borrower’s actions or inactions disqualify it from going forward with the loan. Some of the largest lender liability awards to date have arisen in cases where lenders have been found to have breached their commitments to advance loan funds.

Likewise, once a written commitment has been given (especially if the borrower paid a loan fee for it), it can be dangerous to attempt to add any material condition to the loan documents (for example, financial covenants, or a prepayment penalty clause, etc.) that was not spelled out in the written commitment.

All of this of course assumes that the loan commitment letter clearly states exactly what has been agreed to – which may not always be the case. Washington’s “credit agreement statute of frauds” provides that if a statutory written notice is

¹ I am grateful to Helen Davis Chaitman for her excellent article, “The Ten Commandments for Avoiding Lender Liability” (1988). Most of the following “commandments” are adapted and abridged from her article.



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provided to a borrower, “a credit agreement is not enforceable against a creditor unless the agreement is in writing and signed by the creditor.” See RCW 19.36.110 and 140. The statute further requires that in such a situation “[t]he rights and obligations of the parties to a credit agreement shall be determined solely from the written agreement.” [emphasis added] RCW 19.36.110.

These statutes are designed to protect lenders from being blindsided by alleged oral “side deals” asserted by borrowers. But the purpose of the credit agreement statute of frauds is to prevent inequity, not to shield misconduct. In certain rare situations a court might disregard the statute and look beyond the four corners of the parties’ written agreement if the court determines that a lender has misrepresented something to the borrower, or if the lender is otherwise attempting to use the statute to achieve a result that is fraudulent or unfair to the borrower.

3. Thou Shalt Not Run Thy Borrower’s Business

Be very careful not to insert yourself into the management of your borrower’s business, and avoid controlling the possession or use of the borrower’s assets (other than having liens against the assets). For example, depending upon the circumstances, excessive interference might include:

- Threatening to call a loan if the borrower does not do or refrain from doing something. Such a directive may give rise to a duress claim.
- Attempting to “help” the borrower sell collateral prior to a foreclosure sale. Any prospective purchaser for the lender is also a prospect for the borrower. Communications regarding the collateral by the lender prior to the foreclosure may give rise to a claim of interference by the borrower.
- Attempting to assist the borrower in resolving its problems or other disputes with the borrower’s vendors, subcontractors, or other creditors.

Duress and other interference claims are intensely factual and can be extremely costly to defend. On the other hand, monitoring the borrower’s business, and taking some minor degree of participation in the borrower’s affairs, to the extent necessary to protect the lender’s interest, generally will not render the bank liable to the borrower or to third parties; likewise, providing unbiased information and education to the borrower can be helpful, so long as it does not tend to push the borrower to make a particular choice. On the other hand, the bank’s involvement cannot rise to the level of domination or day-to-day control of the borrower’s affairs.

4. Thou Shalt Not Be Thy Borrower’s Keeper

You should avoid giving advice to a borrower in a default situation (See the previous point.), but you also should avoid giving advice even in non-adversarial situations. Over time, the borrower may increasingly rely on your expertise and guidance, in which case a fiduciary relationship may develop between you and the borrower. If a loan officer’s guidance causes losses to the borrower (or if the borrower believes that the loan officer’s guidance has caused losses), it could lead to a breach-of-fiduciary-duty claim against the lender.

5. Thou Shalt Keep Thine Own Files Clean

Always assume that a jury someday may read any letter, memo, email, or file note in your borrower’s file. Strive to make all of your communications objective, unemotional and accurate. Refrain from using vulgarity, epithets, jokes, threats, or colloquial expressions. As noted above, many jurors tend to identify with borrowers rather than with lenders, and jurors



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therefore may interpret unprofessional communications in the lender's file as a sign that the lender has a disrespectful, cynical, or even predatory regard for the borrower's interests.

6. Thou Shalt Not Tell A Lie (Or Fudge the Truth)

If you respond to credit inquiries, be accurate and complete in your answers, especially if the borrower does not have good credit. The right to financial privacy and other laws make it illegal to disclose certain financial information concerning someone's financial affairs in the making or collection of a loan without the borrower's consent.

In negotiating a workout with a borrower, do not threaten or promise to take action on a loan that you do not intend to carry out. In one Texas case, a court held that a lender's threat to call the borrower's loan and bankrupt the company if a particular board member was elected to be the borrower's CEO (which threat was made as a bluff) constituted a fraudulent misrepresentation on which the borrower reasonably relied in making a disastrous management change, and that the borrower was entitled to \$18.9 million in compensatory damages.

7. Thou Shalt Transfer a Troubled Loan to a Workout Officer

Once a loan account goes bad, it is normal for the loan officer who at one time enjoyed a harmonious working relationship with the borrower to have mixed emotions that could cloud the loan officer's judgment in continuing to handle the account – for example, loyalty to the borrower, and concern that the decline of the borrower's account may reflect adversely on him or her. Workouts should be handled by people who specialize in handling troubled loans, and who can bring an objective perspective to the situation. The original loan officer often will be able to contribute valuable information to the workout team, and in many situations the special credits officer will benefit from the loan officer's input. But it is best to avoid any situation in which the decision whether to settle is made by people who are personally involved in the litigation.

8. Thou Shalt Confer With Thy Workout Counsel

(Unpaid commercial announcement) The complete workout team comprises not only competent, objective in-house workout officers, but also an experienced legal counsel who specializes in handling workouts. This area of the law is developing so rapidly that a lender should retain counsel who fully understands the issues and risks of litigation with a borrower.

9. Thou Shalt Think Carefully Before Suing on a Deficiency

Often a lawsuit against a guarantor to recover a deficiency balance on a commercial borrower's loan following a foreclosure will result in the guarantor filing a counterclaim against the lender. Conversely, in many cases a guarantor will not file a claim if the lender does not sue to recover a deficiency balance. Thus, before deciding whether to file a deficiency suit against a guarantor, the lender should consider carefully (1) whether the guarantor may have insufficient assets to pay a judgment, once won; and (2) whether the lender's actions (e.g., misconduct with respect to the borrower) may have contributed in any way to the need to sue for the deficiency. If the answer is yes to either or both of these questions, then it may be best to write off the deficiency and move on to the next case.

10. Thou Shalt Follow the Golden Rule in Dealing With Thy Borrower

Many unfortunate situations can be avoided altogether if lenders give special attention to their communications with borrowers, and deal with borrowers the way they would expect to be treated if they were the borrowers.

Prior to the consummation of the loan, the lending officer should carefully review the major loan terms with borrowers to avoid (or at least minimize) the possibility that there will be any misunderstandings later.



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In workout situations, the workout officer should consider whether the contemplated action is fair to the borrower and whether any action that may injure the borrower is absolutely necessary to protect the bank's interests. If the officer cannot answer an unqualified "yes" to both questions, it could be a red flag signaling a possible lender liability claim later.

Conclusion

In sum, if one considers the potentially enormous risks and costs of litigating a lender liability claim (not the least of which are the emotional costs to bank employees and their loss of productivity during the litigation), it makes more sense from a business standpoint to expend extra efforts to build and maintain trust and understanding between the lender and the borrower from the outset; and in a workout situation, to deal with the borrower in the same way that the workout officer would want to be treated if he or she were the borrower.