Avoiding Lender Liability

WPASGL March, 2014
Agenda

Avoiding Lender Liability:
• Origination
• Closing
• Servicing/Liquidation
Risks/Rewards of SBA Lending

Rewards:
- Revenue
- Risk Mitigation
- Expanded credit box
- Increased lending limits

Risks:
- Loss of guaranty
- Litigation
- Increased losses
- **Lender Liability**
So you think SBA lending is easy...

DO TELL!...
Origination

Communication

- People
- Documents
- Issues

Rule #1 of Arguing with Lawyers: Tantrums work.
Origination

People:
• Loan officers
• Brokers
• Other Lender employees
People

Loan officers (BDO’s)

• How compensated?
• Incentives?
• Volume?
• Performance?
• Training?
• Hiring?
• To whom is a fiduciary duty owed?
People (Continued)

Brokers (Referral Agents)

– Vetting process?
– Track Record?
– What is the broker’s role?
  • Facilitator or gatekeeper?
– Relationship with loan officer
  • Conflict of interest?
– Independent verification of info. received from Broker
Communications

– Is a lender responsible for its LO’s representations
  – written or oral?
– Can a lender be responsible for a broker’s representations and actions? How?
– Who does Broker represent?
People (Continued)

Representations by LO and BDO (oral or written)

– Fees and costs
– Rate
– Collateral required
– Guarantors needed
– Statements about competitors and their products
People (Continued)

Communication

• What information is requested?
• How do lenders insure accuracy?
• What representations do the BDOs make about the lender, conventional loans and SBA loans?
  – Process?
  – Options?
Documents

Commitment Letter
Term Sheet
Email
Any written (or oral?) communication

...but when I do, I make sure that I issue a detailed Commitment letter that protects my bank with strong "out" clauses!

Ok, so it's not that interesting...
Lender Liability Issues

- Breach of contract
- Fraud
- Interference
- Negligent misrepresentation
- Breach of implied duty of good faith
- Breach of fiduciary duty
- Discrimination
Breach of Contract

Commitment Letter (CL)

• CL is a **contract** the purpose of which is to set forth terms of loan

• Lender’s failure to abide by the contract may damage borrower and give rise to lender liability
Breach of Contract

Commitment Letter
“Obligation” to lend
(conditional or unconditional)
– should include all material
conditions with appropriate
carve outs, exit clauses and
disclaimers (material adverse
changes, compliance with all
SBA reg’s., etc.)
Breach of Contract

• Examples:
  – Wrongfully refusing to honor the loan commitment – Ever happen? Why?
  – Refusing to honor alleged “side deal” between parties (which is known to BDO)
  – Failing to fund, finance or renew a loan
  – Failing to honor agreed-upon modification
  – Expiration – refusal to extend
Interference

• Deal structure
  • Stock purchase/Asset purchase

• Employment Contracts

• Issuing a CL without a bona fide intent to close
  • Get the deal “off the street”

Damages?
Negligent Misrepresentation

Lender misrepresents material fact under circumstances in which it should have known it was false; intent to induce another to act causing injury to borrower

Example:

– BDO learns that appraisal and environmental reports were improperly ordered (late and at wrong address), but assures borrower that loan can be closed within 30 days. Loan does not close within 30 days, as the reports are still not available.
– Lender misrepresented loan status by failing to acknowledge mistake and represent a speedy closing was possible
– Lender’s action in mishandling the loan caused sale contract to expire
Implied Duty of Good Faith

Every contract imposes a duty of G/F and fair dealing; and neither lender nor borrower may do anything to deprive the other of the benefits of the agreement.
Implied Duty of Good Faith

Example #1:

– Lender insists that it cannot close the loan because the 4 optional franchise conditions cannot be met and because a landlord’s consent cannot be obtained (even though there is no liquidation value in the business assets)

– Abuse of discretionary provisions (consents and approvals) in loan documents

– Remedies? Retention of deposit? Borrower remedy for breach? Actual and consequential damages?
Implied Duty of Good Faith

Example #2:

– Lender has total control over disbursements and after an argument with borrower, arbitrarily refuses to advance additional funds needed for renovations

– When should a lender refuse to advance additional funds?

– Under what circumstances would a refusal be proper? Improper?

– How can lender mitigate the risk?
Breach of Fiduciary Duty

Fiduciary: a person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. Thus, a person Is a fiduciary who is invested with rights and powers to be exercised for the benefit of another person.

Fiduciary Duty: When one party must act for another. They are entrusted with the care of property or funds.
Breach of Fiduciary Duty

General rule: debtor/creditor is not a fiduciary relationship.

Fiduciary duties may be created if dependency/control changes relationship.

Under such circumstance, lender may owe a fiduciary duty to borrower (i.e., the borrower should be able to trust and rely upon the representations made by lender’s employees). This means, in part, that the lender must treat borrower fairly, and not exert excessive control.

Example:

Lender provides extra services

- Lender acts as financial advisor on business decisions (deal structure and tax advice) to unrepresented borrower
- Lender drafts legal documents for borrower (lease, operating agreement, etc.)
- Lender controls decision-making process (advises borrower on when and how to purchase equipment and inventory for the business)
Breach of Fiduciary Duty

• Examples:
  – OC as co-borrower or guarantor
  – Equity injection from 401(K) (Peek)
  – Stock purchase/redemption vs. asset purchase

• How to mitigate or eliminate these risks?
• Does lender bear any responsibility?
• Liability for unauthorized practice of law?
Duty of Confidentiality

What duties are owed to borrower at the inception of any loan which must remain confidential?

How does a lender insure that confidentiality is maintained?

What happens to attorney/client privilege if LO attaches “confidential” email from counsel to 3/P?

Examples: Criminal history, alien status, social security number, driver’s license; tax returns

– Liability for lender? Danger? [Risk of sharing information about borrower or its customers to competitor can expose lenders to liability]
Closing

One does not simply...

"close" an SBA loan...
Many lender liability claims are based on two basic types of allegations:

1. “The lender promised me something that is not in the documents, and I relied on that promise to my detriment.”

2. “The lender and I agreed to modify the documents without doing a formal amendment to them.”
INTEGRATION CLAUSE:

- To combat these claims based on facts arising outside of the contract, most contracts have an “integration” clause that states that the written contract is the entire agreement between the parties:

“This instrument constitutes the entire agreement among the Parties relating to the subject matter of this Agreement and there are no agreements, understandings, warranties or representations among the parties relating to the subject matter of this Agreement except as set forth herein.”
DISCLAIMER:

- Integration clauses are good, and worthwhile, but some states won’t strictly enforce them to defeat a fraud claim based on alleged statements made outside of the agreement without an additional statement by the parties disclaiming reliance on those statements:

“The Loan Obligors are not relying on any representations, either written or oral, express or implied, made to any of them by the Lender, any agent or representative of the Lender, other than what is expressly set forth in this Agreement, and the Loan Obligors disclaim any reliance upon any representations that are not expressly set forth in this Agreement.”
No Unwritten Modifications:

• To combat claims based on alleged modifications or amendments to the written agreement, many contracts have a “no unwritten modification” clause:

“This Agreement cannot be modified or amended except by an instrument in writing signed by all parties hereto.”
No Unwritten Modifications:

- Again, those “no unwritten modifications” clauses are good, and worthwhile, but a better clause would make clear that only documents expressly intended to modify the agreement actually amend the agreement:

  “Neither this Agreement nor any of the provisions hereof can be changed, waived, modified, amended, discharged or terminated, except by an instrument in writing signed by the Party against whom enforcement of the change, waiver, modification, amendment, discharge or termination is sought stating that the Agreement ‘is to be changed,’ ‘is to be waived,’ ‘is to be modified,’ ‘is to be amended,’ ‘is to be discharged,’ and/or ‘is to be terminated.’”
Loan Document Clauses

SPOUSES:

- Typically, lenders who know that some of their collateral is held by a husband and wife (as tenants by the entireties) will require loan guarantees from both spouses.

- That situation typically leads to liquidation counsel suing both spouses jointly in a single lawsuit as “husband and wife.”
Preserving The Ability to Pursue Collateral Held By The Entireties

- However, in separate cases in NC and PA, the plaintiff lender obtained individual judgments against each spouse on separate guarantees and then asked the court to consolidate them so that it could pursue a property held by the spouses by the entireties.
Loan Document Clauses

• Avoid this whole issue by having husband/wife execute one guaranty or adding this clause to each guarantor’s guaranty:
  • “I hereby understand and agree that this guaranty agreement is intended to create a joint liability with the guaranty executed by [guarantor #2] on [date]. I hereby permanently and irrevocably waive any protections of tenancy by the entireties to which I may be entitled, to the extent that those protections are applicable now or may be applicable in the future. I understand and acknowledge that, should [lender] obtain a judgment against me for liability on this guaranty agreement, assets that are jointly held by me and [guarantor #2] by the entireties can be executed upon by [lender] in satisfaction of the debt referenced herein. I agree to promptly execute a joint written guaranty agreement along with [guarantor #2] upon [lender’s] request.”

• Remember 148 and 148L forms no longer mandatory but time-tested.
• Add Addendum to 148s?
COUNTERPARTS

To permit execution of the agreement by several parties in different locations at different times, many contracts have an “execution in counterparts” clause:

“This agreement may be executed in any number of counterparts and by different parties in separate counterparts. Each counterpart when so executed shall be deemed to be an original and all of which together shall constitute one and the same agreement.”
Loan Document Clauses

• The basic clause should be improved to allow for electronic execution and require delivery:

“This Agreement may be executed in one or more counterparts, each of which shall be deemed an original, but all of which together will constitute one and the same instrument. This Agreement may be executed by facsimile signature, e-mailed portable document format (“PDF”) signature, or original signature. Any facsimile signature or e-mailed PDF signature shall be deemed an original and have the same effect as an original. This document will not be binding on or constitute evidence of a contract among the parties until such time as a counterpart of this document has been executed by each Party and a copy thereof delivered to the other Parties to this Agreement.”
E-signature and Electronic Records

- Execution by electronic signature is becoming more common. The Uniform Electronic Transactions Act (UETA) has been adopted in 47 states, DC, Puerto Rico & the Virgin Islands. Three states, Illinois, New York and Washington, have not adopted the uniform act, but have their own statutes pertaining to electronic transactions. In addition, Congress enacted the Electronic Signatures in Global and National Commerce Act (E-SIGN) that also establishes the validity of electronic records and signatures. SBA One is Agency’s attempt to adapt.

- Always check modification of loan documents with bank counsel!!
Servicing and Liquidation

Y U No pay your SBA loan?
Loan Modifications

Examples include: increases in loan amounts, changes in loan terms, construction problems, failure to provide financial information and changes in term of loan

– Temporary or permanent?
– Need to avoid novation (substitution of new contract for old one whereby new agreement extinguishes rights under former agreement)

• How does a lender avoid novation?
– Loan deferments: Other than a one-time 3 month deferment, what risks do lenders run by offering more? May lender be “estopped” from declining a request for deferment if its LO has promised one?
Insurance Issues

Under what circumstances should lenders force place insurance?

Under what circumstances should a lender not force place insurance?

Can placement/non-placement of insurance give rise to liability?

What information should lenders disclose?
Construction Loans

- Lender assumes responsibility or right to disburse proceeds to parties other than borrower (should lender disburse proceeds to borrower other than w/c?)
- Lender is apprised of construction deficiencies and does nothing
- Lender is advised by borrower to withhold additional disbursements (or to pay subcontractors directly)
- Lender disregards borrower’s complaints and continues to disburse proceeds without a bona fide attempt to investigate the truth of the complaints
1. Risk to lender if it artificially prolongs an insolvent company’s existence, and these actions jeopardize borrower’s ability to satisfy claims of other creditors because of
   • an increase in debt; or
   • reduction in available assets
2. “Artificially” prolonging a debtor’s existence is commonly done by forcing debtor to stretch trade or grow trade debt to keep debtor open long enough for borrower to collect A/R for SBA lender’s benefit
3. Use of “Pre-Negotiation Letters”
4. Does the covenant of good faith impose a duty to forbear?
Liquidation

Placing a defaulting loan into liquidation status and accelerating indebtedness must be based on a “material” default. What does this mean? Covenant of Good Faith?

Should a lender become involved in the day-to-day management and operations of the business?

During work out, should a lender control the borrower’s assets, stock and management?

– Would such actions create a fiduciary relationship?
– If a lender takes over the business’ operations,
– may it expose itself to tax liability?
Summary

Integrity counts – make it part of your entire institution’s mission. Never stretch the truth in answering inquiries.

When unsure, ask and always document

Honor commitments to borrowers: never make representations inconsistent with the commitment.

If providing advice to a borrower, suggest – in writing - that borrower’s counsel and other advisors be consulted

On delicate communications over the phone, have at least 2 people on the call

Other delicate communications should be directed to counsel and oral communications should be timely documented
Summary

Avoid involvement in managing borrower’s business

All written memos to file should be objective, unemotional and accurate

Negotiations handled appropriately and in good faith

When considering suing on a deficiency, always consider that a counterclaim could be far more expensive to defend

Treat borrowers with respect
Questions

What if...

I didn't understand any of that?
Thank you!

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