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Revisiting lender liability claims under new theory

Courts have split over recognition of deepening insolvency tort claims.

By Benjamin Mintz
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IN THE MID-1980S, a series of multimillion-dollar jury verdicts and a few renowned court decisions imposing liability on lenders under then-developing legal theories resulted in an explosion of lender liability claims. By the late 1980s and early 1990s, however, the courts had materially constrained the bases upon which lender liability could be imposed. In recent years, lender liability claims have again become a focal point of litigation, albeit this time based on alternative and novel legal theories (such as deepening insolvency) that were not otherwise at the forefront of the 1980s litigation activity.

How this trend ultimately plays out and particularly whether the courts ultimately expand or constrain these alternate liability bases remains to be seen. However, two recent circuit court decisions, *In re Sharp International Corp.*, 403 F.3d 43 (2d Cir. 2005), and *B.E.L.T. Inc. v. Wachovia Bank*, 403 F.3d 474 (7th Cir. 2005), are significant insofar as they refused to impose liability on lenders based on relatively novel liability theories.

Before turning to these recent decisions, it is important to first look back to the original rise and fall of lender liability claims to appreciate the current context. It is also worth highlighting that lender liability is not and has never been an independent cause of action as such, but instead is a broad reference to the various bases upon which lenders may face liability, traditionally including claims for breach of contract, breach of good faith, fraud, misrepresentation, breach of fiduciary duty and interference with business relations.

Commentators have generally identified two bellwether decisions as spawning the lender liability boom in the 1980s: *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985), and *State National Bank v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. App.—El Paso 1984). In *K.M.C.*, the lender, in accordance with the express terms of the loan agreement, terminated its financing to the borrower without any advance notice. Following the collapse of its business, the borrower sued the lender, contending that the sudden termination violated the lender's duty of good-faith performance that was inherent in the loan agreement.

The 6th U.S. Circuit Court of Appeals, despite recognizing that the lender acted in conformity with the express terms of the loan agreement when it terminated the financing, held that the lender's decision whether or not to advance funds was limited by an obligation of good faith and reasonableness, meaning that, under the circumstances, the lender was required to provide advance notice of termination (even though the agreement did not require any such notice).

Moreover, the court held that the lender's power to demand repayment of the loan was also constrained by a duty of good faith—a result that was expressly contrary to the Official Comment to Uniform Commercial Code 1-208, which states that the UCC's good-faith provision does not have any application to "demand instruments or obligations whose very nature permits calls at any time with or without reason." Thus, *K.M.C.* enabled plaintiffs to circumvent otherwise clear and express contractual terms by contending that the lender breached its duty of good faith.

> **Two decisions from this year rejected other novel claims.**

More claims against lenders

This opened a very large door for borrowers (and their representatives) in pursuing liability claims against lenders. While disputes regarding contractual provisions are often resolved on a motion to dismiss or for summary judgment, contentions regarding a lender's breach of its duty of good faith are more amorphous, subject to factual evaluation and thus typically less suitable for resolution by pretrial motion practice.

In *Farah Mfg.*, the lender had advised the borrower that it would enforce a management-change clause in the loan agreement and terminate the loan if the borrower proceeded with its plan to restore its previously displaced chief executive officer to that position. Based on the lender's opposition, the borrower did not make any management change; the borrower's business continued to decline until its former CEO regained control a year later and restored the borrower to profitability. The appellate court upheld a jury award against the lender, and, in doing so, expanded lender liability law by recognizing a novel liability theory—interference with corporate governance.

The court also upheld the borrower's fraud claim, finding that the lender's threat to call the loan if management were changed was a fraudulent misrepresentation because the lenders never intended to do so. The court also upheld the borrower's duress claim, finding that the lender's threats to, and intimidation of, the borrower constituted actionable economic duress. Taken to its logical extreme, *Farah Mfg.* effectively undermines a lender's ability to protect itself against management changes that it is not comfortable with.

K.M.C. and *Farah Mfg.* were significant, not only because of the expansive liability theories that they propounded, but also because of the magnitude of the damages awards that were imposed. In each case, the lender was held liable for the borrower's lost profits that could not be realized as a result of the lender's conduct, amounts which did not bear any relation to the amount of the loans at issue. In *K.M.C.*, the award was $7.5 million; the loan at issue was $3.5 million. In *Farah Mfg.*, the award was $18 million; the loan at issue was $22 million.

A backlash to expansive lender liability theories began to develop shortly following the *K.M.C.* and *Farah Mfg.* decisions, and many courts expressly repudiated the results reached in those decisions. For example, in *Kham & Nate's Shoes No. 2 Inc. v. First Bank*, 908 F.2d 1351 (7th Cir. 1990), the 7th Circuit rejected the *K.M.C.* approach, holding that principles of good faith could not be used to override or block clear and express contractual terms; rather, good- faith principles could only apply to fill gaps that the contract did not expressly address. Numerous other courts have reached a similar result. See, e.g., *National Westminster Bank U.S.A v. Ross*, 1991 U.S. Dist. Lexis 10586 (S.D.N.Y. July 31, 1991); *Taggart & Taggart Seed Inc. v. First Tenn. Bank Nat'l Ass'n*, 684 F. Supp. 230 (E.D. Ark. 1988), aff'd 881 F.2d 1080 (8th Cir. 1989).

Similarly, most other courts have not recognized a lender's interference with a borrower's corporate governance as an independent basis for liability. See, e.g., *Flintridge Station Assocs. v. American Fletcher Mortgage Co.*, 761 F.2d 434, 442 (7th Cir. 1985) (lender may condition loan term on borrower's disassociation from individual); see also *Ed Wolf v. National City Bank, Cleveland*, 1997 Ohio App. Lexis 237 (Ohio Ct. App. Jan. 23, 1997) (refusing to

Benjamin Mintz is a partner in the business reorganization and creditors' rights department at New York-based Kaye Scholer.

recognize an interference with corporate governance cause of action under Ohio law).

Deepening-insolvency theories

As a consequence of the courts' backlash against expansive lender liability claims, borrowers' claims against lenders remained relatively confined until the last few years when borrowers (and their representatives) begin to seek to impose lender liability based on a theory of deepening insolvency, a novel theory which some courts embraced. Deepening insolvency is a doctrine by which the bankrupt company (or its representative) may recover damages from its lender on the ground that the lender controlled the company or misrepresented the company's financial condition to prolong artificially the company's existence to the detriment of creditors and other third parties.

It was traditionally recognized only as a theory of damages, but in recent years has been recognized by some courts as an independent tort action. *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001) (Pennsylvania law); *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs. Inc.)*, 299 B.R. 732 (Bankr. D. Del. 2003) (Delaware law); *In re Flagship Healthcare Inc.*, 269 B.R. 721 (Bankr. S.D. Fla. 2001) (Florida law).

Yet other courts have rejected or questioned the viability or scope of deepening-insolvency claims. See, e.g., *Coroles v. Sabey*, 79 P.3d 974 (Utah Ct. App. 2003) (rejecting deepening insolvency as a theory of damages); *Florida Dep't of Ins. v. Chase Bank of Texas Nat'l Ass'n*, 274 F.3d 924 (5th Cir. 2001) (questioning whether Texas would recognize deepening insolvency as a cause of action); see also *Kittay v. Atlantic Bank of New York (In re Global Service Group LLC)*, 316 B.R. 451 (2004) (not determining whether New York law recognizes deepening insolvency as an independent tort, but instead holding, among other things, that a lender's prolonging the life of an insolvent company that continues to incur debt does not, without more, state a valid claim for relief).

At this time, given the recent emergence of deepening insolvency as an independent tort and the inconsistent case law, it is difficult to predict how favorably and broadly the courts will apply deepening-insolvency liability theories. For example, while some courts have recognized deepening insolvency as an independent tort, it remains to be seen what type of conduct will be sufficient to make out such a claim (i.e., is fraud by the lender required or is mere negligence sufficient?). Until the deepening-insolvency doctrine is further developed and the courts offer a more consistent and clear approach in applying the doctrine, a new flood of lender liability claims testing the breadth and scope of the deepening-insolvency doctrine is likely.

In considering deepening-insolvency claims, it is also important to be mindful of the in pari delicto defense that may operate to shield a lender from such claims. Subject to certain exceptions (which are beyond the scope of this article), the in pari delicto defense operates to prevent a company (or its representatives) from recovering from third parties (including lenders) that may have aided the company in undertaking wrongful conduct. Accordingly, in many circumstances, lenders will be protected from deepening-insolvency claims brought by the company or its representative by the in pari delicto defense—since in all likelihood the company itself will necessarily have been the lead participant in the efforts to prolong its own existence. See, e.g., *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001).

Pari delicto defense may shield lenders from such claims.

In re Sharp Int'l Corp., 403 F.3d 43 (2d Cir. 2005), and *B.E.L.T. Inc. v. Wachovia Bank*, 403 F.3d 474 (7th Cir. 2005), do not involve deepening-insolvency claims per se, but instead address other novel lender liability theories. Particularly, in each case, the lender was alleged to have been aware of the borrower's ongoing fraudulent conduct and, instead of taking action to stop the fraud, received loan repayments. Each of the courts rejected the plaintiffs' liability theories and dismissed the action against the lender.

In *Sharp Int'l*, the lender, after extending a loan to the borrower, began to suspect that the borrower and its principals were committing fraud (by reporting fictitious clients and accounts receivables and by the principals looting the borrower). The lender, allegedly aware of the borrower's and the principals' fraud, demanded repayment of its loan, which the borrower arranged by securing additional financing from its noteholders. More than 90 days later (after the preference period had run), the fraud was revealed and the noteholders commenced an involuntary Chapter 11 proceeding against the borrower. The borrower-debtor sued the lender, asserting that the lender had aided and abetted the principals' breaches of fiduciary duty, as well as asserting claims for constructive fraudulent conveyance and intentional fraudulent conveyance.

The 2d Circuit held that the aiding and abetting claim failed because there were no allegations that the lender affirmatively assisted the principals' breaches of fiduciary duty. In particular, the court held that the lender's demand for repayment of a bona fide debt cannot be the basis for aider and abettor liability. Moreover, the court held that the lender's failure to disclose the fraud to other creditors and its failure to foreclose on the borrower could not constitute affirmative assistance of the fraud. The court likewise upheld the dismissal of the fraudulent conveyance claims, reasoning that the loan repayment was "at most a preference between creditors" which cannot in itself constitute bad faith even if the preferred creditor was aware that the debtor was insolvent. Nor could the lender's knowledge as to the allegedly improper source of the repayment (i.e., that the debtor incurred the debt from the noteholders fraudulently) establish a lack of good faith by the lender.

B.E.L.T. involved similar facts to *Sharp Int'l* as well as a similar result. Various lenders to the borrower sued the defendant-lender, contending that they had furnished the monies to the borrower which were used to repay the defendant-lender. They alleged that the defendant-lender stopped making loans to and demanded repayment from the borrower because it knew that the borrower was financially unstable and it suspected that the borrower was committing fraud. The 7th Circuit held that the plaintiffs lacked a viable legal theory against the defendant-lender. Like the 2d Circuit, the 7th Circuit characterized the plaintiffs' claims as nothing more than an attempt to avoid a preference among creditors, something which (absent a bankruptcy proceeding) was not a basis for liability.

Both *Sharp Int'l* and *B.E.L.T.* also observed that a creditor does not have an affirmative duty to inform other creditors of the borrower's fraudulent conduct. In fact, the court in *B.E.L.T.* noted that state and federal law imposed confidentiality on banks requiring banks not to tell other parties about the borrower's activities.

Sharp Int'l and *B.E.L.T.* are thus significant milestones for lenders. They affirm a lender's ability to act in conformity with the express terms of its loan agreement, including to seek repayment of its loan irrespective of what it may or may not know about the borrower. This result is thus one more nail in the coffin of *K.M.C.*'s legacy, which—in marked contrast to *Sharp Int'l* and *B.E.L.T.*—imposed a good-faith requirement on a lender's demand for repayment. Whether the imposition of such a requirement would have caused a different result under the circumstances in *Sharp Int'l* and *B.E.L.T.* remains to be seen, but it is noteworthy that neither the 2d Circuit nor the 7th Circuit apparently believed that such a requirement was applicable to the lender's repayment demand.

The specter of lender liability claims remains a substantial cause for concern for lenders, particularly in view of the uncertain scope of deepening-insolvency claims, and lenders should no doubt guide their course of conduct in an effort to avoid such liability. Nonetheless, the decisions in *Sharp Int'l* and *B.E.L.T.* should offer some degree of comfort to lenders that find themselves in a situation where they want to extract themselves from a situation with a "bad" borrower. NLJ