Lender Liability Considerations

Lender liability is the result of a lender's conduct; it is not an activity. Generally, lender liability arises from either a breach of a common law (or judicially created) obligation or a violation, whether intentional or inadvertent, or a breach of a federal or state statutory obligation. Thus, liability has been found where a lender exercises excessive control over a borrower's affairs, engages in inequitable or fraudulent conduct with respect to the borrower or other creditors of the borrower, or engages in conduct proscribed by applicable federal or state laws. In these circumstances, the lender may be held liable to the borrower or third parties for damages or penalties, may find its claims equitably subordinated to claims of others, or may have its claims avoided entirely.

The imposition of a common-law duty of a lender to a borrower or a third party derives primarily from the lender's exercise of "control" over the borrower. Although the leverage that lenders often have in negotiating loan documents, particularly in a default/restructuring scenario, and the loan documents themselves (e.g., contractual provisions that restrict the borrower's activities or require the borrower to take certain actions in the event of default) arguably could constitute a starting point for purposes of establishing lender liability, the leverage itself does not equal control.[1] Indeed, the trend in courts has been to exonerate a lender that has acted strictly within the terms of its agreement with the borrower as long as its actions have been reasonable. The actions of the lender with respect to an agreement's provisions and remedies, not their mere existence, may be the basis for a court's finding of liability. Thus, advice to lenders and borrowers depends on an analysis of the facts and circumstances of the individual case and frequently requires difficult judgments in balancing the lender's interest in maximizing its recovery against the risks inherent in the lender's assertion of its contractual rights.

In addition to a common-law duty, the lender, through the activities of the borrower, is subject to provisions of tax laws, federal and state securities laws, the Fair Labor Standards Act[2] (FLSA), and the Racketeer Influenced and Corrupt Organization Act[3] (RICO), among others. Failure to comply with these statutory requirements may subject the lender to civil fines or penalties.

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[1] Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 609 (2d Cir.), *cert. denied*, 464 U.S. 822 (1983).

[2] 29 U.S.C. §§ 201-219 (1994).

[3] 18 U.S.C. §§ 1961-1968.

LENDER-BORROWER RELATIONSHIP

The mere existence of a lender-borrower relationship does not impose fiduciary obligations on the lender.[4] "Ordinarily, the relationship between a bank and its customer is one of debtor and creditor . . . . [a]nd the duty owed for simple negligence is one of ordinary care."[5] Indeed, "except in special circumstances, a bank does not have a fiduciary relationship with its borrowers."[6] If, however, "there is a confidential relationship between a bank and its customer, a fiduciary obligation might be imposed on the bank."[7] Such a duty is implied by law and its existence, imposition and breach depends upon specific factual circumstances.[8]

A confidential relationship is created when trust is reposed by one party in another with resulting superiority and influence exercised by the other.[9] The existence of a confidential relationship alone, however, is not sufficient to impose liability on a lender for breach of fiduciary duty. For instance, to establish liability, some courts have required that the borrower also demonstrate that the lender inequitably abused that confidence by wrongfully using its position of superiority in order to obtain an unconscionable advantage over the other party.[10] For example, in *Hoffman v. Lincoln National Bank & Trust Co.*,[11] the individual plaintiffs cited the following, among other things, as evidence of a confidential relationship:

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[4] *See*, *e.g.*, Sallee v. Fort Knox Nat'l Bank, N.A. (*In re* Sallee), 286 F.3d 878, 893 (6th Cir. 2002); Forsythe v. BancBoston Mortgage Corp., 135 F.3d 1069, 1077 (6th Cir. 1997); *W.T. Grant*, 699 F.2d at 609; Paradise Hotel Corp. v. Bank of Nova Scotia, 842 F.2d 47, 53 (3d Cir. 1988); Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A., 731 F.2d 112, 122 (2d Cir. 1984); Knapp v. Am. Gen. Fin., Inc., 111 F. Supp. 2d 758, 766 (S.D.W. Va. 2000); Globe Motor Car Co. v. First Fidelity Bank, N.A., 641 A.2d 1136 1138-39 (N.J. Super. Ct. 1993), *aff'd*, 677 A.2d 794 (N.J. Super. Ct. App. Div. 1996).

[5] Mans v. Peoples Bank, 10 S.W.3d 885, 889 (Ark. 2000); *see also* General Motors Acceptance Corp. v. Baymon, 732 So.2d 262, 270 (Miss. 1999) ("the general rule is that there is no presumption of a fiduciary relationship between a debtor and creditor") (internal quotations and citations omitted).

[6] *See*, *e.g.*, *Sallee*, 286 F.3d at 893.

[7] Hoffman v. Lincoln Nat'l Bank & Trust Co., 636 N.E.2d 185, 188 (Ind. Ct. App. 1994); *see also* Bear Stearns & Co. v. Daisy Sys. Corp. (*In re* Daisy Sys. Corp.), 97 F.3d 1171, 1177-78 (9th Cir. 1996) (finding confidential relationship to be necessary to determine whether a bank owes a fiduciary duty).

[8] *See*, *e.g.*, Susan Fixel, Inc. v. Rosenthal & Rosenthal, Inc., 842 So. 2d 204, 207-08 (Fla. Dist. Ct. App. 2003); Stokes v. Henson, 217 Cal. App. 3d 187, 194 (1990). Some courts have "presumed" a confidential relationship if there is an agency relationship between the parties. *See*, *e.g.*, *Daisy Sys. Corp.*, 97 F.3d at 1178.

[9] *See*, *e.g.*, *Sallee*, 286 F.3d at 892-93; Amendola v. Bayer, 907 F.2d 760, 763 (7th Cir. 1990); *In re* Handy & Harman Ref. Group, Inc., 293 B.R. 299, (Bankr. D. Conn. 2003).

[10] *Hoffman*, 636 N.E.2d at 188. *But see* Groob v. KeyBank, 843 N.E.2d 1170 (Ohio 2006) (prospective lender not liable for breach of fiduciary duty when loan agent used confidential information for her own benefit).

[11] 636 N.E.2d 185.

the plaintiffs were unsophisticated in financial matters;

all their banking had been with the defendant and they had turned to the bank for most of their financial needs and advice;

they had relied on the bank for guidance in financing the project which was the basis of the suit; the bank had encouraged them to begin construction of the project before the loan closed; and the bank knew prior to making the loan that the plaintiffs' business was undercapitalized.

Even if, however, the actions of the lender in *Hoffman* did create a confidential relationship, the court held that the plaintiffs had failed to demonstrate that the bank gained an unconscionable advantage by abusing it. As *Hoffman* noted, the bank itself had lost more than $70,000 on the transaction at issue.

Other courts may use different language to describe the existence of a fiduciary relationship, but apply a test similar to the confidential relationship/ unconscionable advantage standard employed in *Hoffman.* For example, in *Capital Bank v. MVB, Inc.*, the court held that it would "recognize a fiduciary relationship between a bank and a customer where the bank knows or has reason to know of the customer's trust and confidence under the circumstances exceeding an ordinary commercial transaction."[12] In this case, a bank's loan officer expressly invited the borrower's reliance and trust in the bank and the bank was aware of such reliance, which established a confidential relationship between the bank and the borrower. In addition, the bank urged the borrower to purchase the assets of a financially troubled company, despite the bank's knowledge that the equipment to be purchased consistently malfunctioned. The court found that the officer had encouraged the sale in order to provide the troubled company with funds to repay a loan to the bank. In this case, the bank's unfair manipulation of the borrower to satisfy the bank's claim, coupled with the existence of a confidential relationship, was sufficient to support a finding that the bank had breached its fiduciary duty to the borrower.

A lender may be liable to a borrower or a third party even if the lender does not take advantage of a confidential relationship. For instance, actions of a lender that result in harm to the borrower or its creditors, when coupled with a finding that the lender controlled or dominated the borrower, may lead a court to find the lender liable to the borrower and the borrower's creditors and shareholders. For example, a lender's ownership of an equity interest in the borrower, particularly stock with voting rights, may provide the lender with the power to control or influence the borrower's management once it has the right to exercise such voting rights. Although merely taking a pledge of stock as collateral for a loan does not evidence control, a lender that exercises voting rights of pledged stock, following an event of default, to elect directors and influence the day-to-day affairs and business decisions of the borrower may be found to be in a control

[12] 644 So. 2d 515, 521 (Fla. Dist. Ct. App. 1994).

position.[13] In the context of ownership of a pledge of stock, it is not the potential to exercise, but the actual exercise, of control that will be a factor in determining lender liability.[14]

A lender's influence over the composition of its borrower's board and management through means other than the ability to vote for directors also may expose the lender to liability. For instance, in *State National Bank v. Farah Manufacturing Co.*,[15] a public company's loan agreement provided that a change in management would constitute an event of default if for any reason any two lenders considered that change to be adverse to their interests. The management change clause alone did not give rise to the borrower's lender liability claim. Rather, it was that the lenders led the borrower's board of directors to believe that the lenders would accelerate the loan and force the company into bankruptcy if management unacceptable to them was installed.

The evidence at trial demonstrated, however, that the lenders had either decided not to declare a default or reached no decision on the matter. But the lenders had used their leverage under the management change clause to cause the board not to elect Mr. Farah as chief executive officer, to prevent the election of two directors, to pack the board with the lenders' hand-picked nominees (even though the loan agreement did not specify an event of default if board members unacceptable to the bank were selected), to encourage a proxy fight against Mr. Farah, and under the auspices of the chief executive officer installed by the lenders, to auction off assets of the borrower.

Ultimately, Mr. Farah assumed the position of chief executive officer and directed the borrower in the prosecution of claims against the lenders, including fraud, duress, and tortious interference with the borrower's business relationship. The borrower successfully claimed that by installing incompetent management and preventing the election of competent management, the lenders caused losses and damage to the borrower's businesses. The borrower ultimately recovered a multimillion dollar judgment against the lenders.

Farah presents a situation in which lenders controlled the borrower's management by making bad faith threats to exercise remedies under their loan agreement with the borrower. These bad faith threats were the basis of the borrower's successful fraud claim against the lenders. A lender that "takes control" of the management of its borrower and makes the borrower's policy and management decisions risks exposure to causes of action for damages resulting from its exercise of control.

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[13] Citibank, N.A. v. Data Lease Fin. Corp., 828 F.2d 686 (11th Cir. 1987), *cert. denied*, 484 U.S. 1062 (1988).

[14] *See* Metge v. Baehler, 762 F.2d 621, 631 (8th Cir. 1985), *cert. denied*, 474 U.S. 1057 (1986).

[15] 678 S.W.2d 661 (Tex. Ct. App. 1984) (writ granted, judgment set aside, cause dismissed).

Notably, third parties, as well as the borrower, may recover their losses and other damages from the lender.[16] For example, in two decisions arising from related transactions, the court upheld a jury verdict finding the lender liable for losses suffered by the borrower and upheld the claim of a customer of the borrower based on a showing that the lender had misrepresented the borrower's financial condition.[17] In one of the decisions, the court noted that the lender's supervision of payments, the reduction of the salary of the borrower's president by fifty percent, and the hiring of an accountant chosen by the lender could be considered evidence that the lender had taken control of its borrower.[18]

Courts generally have been reluctant to impute control of the borrower to a lender that acts in good faith simply to safeguard its interests.[19] Several courts have explained that lenders should be given a fair amount of latitude to protect their own interests as creditors.[20] Failed borrowers and their creditors and shareholders often cite the "totality" of a lender's involvement in the borrower's financial affairs, however, in the hope that the sum of the lender's actions will equal "control" of the borrower and its corollary, financial responsibility to third parties.[21]

In the seminal case, *A. Gay Jenson Farms Co. v. Cargill, Inc.*,[22] creditors of the borrower successfully asserted claims against the lender as a principal on the borrower's contracts for the sale of grain. The court cited the following as indicia of the lender's control over the borrower's financial affairs: the lender critiqued and made recommendations to the borrower; the lender had the right of first refusal to purchase the

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[16] Lease & Rental Mgmt. Corp. v. Arrowhead Cent. Credit Union, 24 Cal. Rptr. 3d 483, 487, (Ct. App. 2005) (identifying cases that recognize liability to third parties and cases that refuse to impute liability to lenders for losses by third parties).

[17] Cent. States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405 (6th Cir. 1984); Melamed v. Lake County Nat'l Bank, 727 F.2d 1399 (6th Cir. 1984).

[18] *See Melamed*, 727 F.2d at 1403-04. For a discussion of steps a senior lender may take during restructuring negotiations, see Chapter 2.

[19] *See, e.g.*, Cossoff v. Rodman (*In re* W.R. Grant Co.), 699 F.2d 599, 610 (2d Cir.) (noting that it is permissible for lenders to use leverage to "recoup the most amount of money possible" and to closely monitor a borrower without being found to be controlling the borrower), *cert. denied*, 464 U.S. 822 (1983).

[20] *Id.*

[21] *See, e.g.*, Paracor Fin., Inc. v. Gen. Elec. Capital Corp., 79 F.3d 878, 890 (9th Cir.) (lender that was to receive a portion of debenture sale proceeds was not a controlling person, as it exercised no day-to-day control over the company; inquiry must focus on the " 'management and policies' of the company and not on the discrete transactions") (citation omitted), *aff'd in part, rev'd in part on other grounds*, 96 F.3d 1151 (9th Cir. 1996); *see also* Neilson v. Union Bank, 290 F. Supp. 2d 1101, 1116 (C.D. Cal. 2003) (In alleging control of lender, "[c]onclusory allegations of 'alter ego' status are insufficient to state a claim. Rather, a plaintiff must allege specifically both of the elements of alter ego liability, as well as facts supporting each.") (citations omitted).

[22] 309 N.W.2d 285, 290-91 (Minn. 1981).

borrower's grain; the borrower could not enter into mortgages, purchase stock, or pay dividends without the lender's approval; the lender had the right to enter the borrower's premises for periodic checks and audits; the lender issued an internal memo stating the need for "strong paternal guidance" of the borrower; the lender's name was imprinted upon the drafts and forms furnished to the borrower as samples; the lender financed all the borrower's purchases of grain and operating expenses; and the lender could discontinue financing. In *Cargill*, the lender's actions were sufficient for the court to determine that the borrower and the lender actually had an agency relationship, with the borrower acting as the agent of the lender.[23]

Likewise, in *Connor v. Great Western Savings & Loan Ass'n*,[24] purchasers of homes from a construction company successfully sued the construction company's lender on a theory of negligence in the construction of the homes. The lender's duty to the purchasers arose from the lender's intimate involvement in its borrower's financial affairs, which included the lender's knowledge of the borrower's thin capitalization, its financing of the land purchase, its active role in the construction of homes, and its right of first refusal to make loans to purchasers of homes. In essence, the *Connor* court held that the lender had a duty to exercise reasonable care to protect the purchasers from damage caused by major structural defects.

Circumstances also may give rise to liability of a lender to a borrower for the decline in the value of a third-party corporation's stock pledged by the borrower as collateral. If the lender uses its rights and remedies with respect to the pledged stock to exercise control over the corporation, the lender must exercise reasonable care as a pledgee. In *Citibank, N.A. v. Data Lease Financial Corp.*,[25] the pledge agreement provided that in the event of a default, the lender could exercise voting rights with respect to the stock. On the borrower's default, the lender exercised those rights and installed

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[23] *Id.; see also* Korea Exp. USA, Inc. v. K.K.D. Imports, Inc., No. 99 Civ. 5140 (NRB), 1999 WL 1034755, at *1 (S.D.N.Y. Nov. 15, 1999) (recognizing *Cargill's* continuing vitality and describing the case as "seminal").

[24] 447 P.2d 609, 617 (Cal. 1968). The scope of the *Connor* ruling was limited by statute. The California Civil Code provides as follows:

> A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property for sale or lease to others, shall not be held liable to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacture, construction, repair, modification or improvement of such real or personal property, unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property.

Cal. Civ. Code § 3434 (1997).

[25] 828 F.2d 686 (11th Cir. 1987), *cert. denied*, 484 U.S. 1062 (1988).

new management of the corporation. Subsequently, the value of the stock declined significantly. Two years after the lender began voting the pledged stock, foreclosure proceedings were commenced against the corporation whose stock the lender held. Two months later, the court ordered an emergency judicial sale of the pledged stock that was purchased by the lender.

The borrower alleged that the decline in value of the stock from the time it was pledged to the time of the judicial sale was so great that the lender's actions constituted conversion. The court held that the borrower had stated a cause of action against the lender based on the lender's statutory duty of reasonable care as a pledgee, and ruled that "when the pledged stock represents a controlling interest and the pledgee becomes involved in the management of the company . . . its duty of reasonable care follows it and attaches to all its activities." Although the lender's actions were not as egregious as those in *Farah,* it is clear a lender must exercise reasonable care even when technically acting within the rights set forth in the loan documents.[26]

LIABILITY FOR CONSTRUCTIVE FRAUD OR IMPLIED DUTY OF GOOD FAITH

CONSTRUCTIVE FRAUD AND FAILURE TO DISCLOSE

If a lender benefits from misrepresentations it made to a borrower, that lender may be liable on a constructive fraud theory even if it lacked fraudulent intent. In certain instances, courts also have imposed liability for a lender's failure to disclose information to third parties. The case law reflects that, ordinarily, a lender is under no duty to disclose information to third parties, but it may be liable for negligently representing inaccurate facts. These cases are based on the lender's relationship with the borrower, although not on the lender's control or fiduciary obligation.

For example, in *Central States Stamping Co. v. Terminal Equipment Co.*, the court held that a duty to disclose information does not depend on the existence of a fiduciary relationship, but rather, arises "in any situation where one party imposes confidence in the other because of that person's position, and the other party knows of this confidence."[27] The court held that a lender does not have a duty to disclose

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[26] *But see, e.g.*, Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693, 700 (5th Cir. 1990) (holding that evidence that lender acted outside of rights in loan agreement was insufficient); Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 609–10 (2d Cir.), *cert. denied*, 464 U.S. 822 (1983) (lender within rights to enforce agreement); Anaconda-Ericsson, Inc. v. Hessen (*In re* Teltronics Servs., Inc.), 29 B.R. 139, 172 (Bankr. E.D.N.Y. 1983) (evidence insufficient to establish that borrower relied on representations by lender regarding financing).

[27] 727 F.2d 1405, 1409 (6th Cir. 1984) (citation omitted); *see also* Sallee v. Fort Knox Nat'l Bank (*In re* Sallee), 286 F.3d 878, 896 (6th Cir. 2002) ("Where one party to a contract knows the other relies on him to disclose all material facts, the duty rests on him not to conceal anything material to the bargain or assume responsibility for damage caused by the concealment."); Andersons, Inc. v. Consol, Inc., 185 F. Supp. 2d 833, 843-44 (N.D. Ohio 2001), *aff'd*, 348 F.3d 496 (6th Cir. 2003).

information, but once it does so with the knowledge that a third party will rely on the information, the lender must represent the facts accurately.[28]

In *Barnett Bank v. Hooper*,[29] the court held that when a lender is involved in a transaction with a borrower with which it has established a relationship of trust and confidence, the lender may be found to have assumed a duty to disclose to the borrower facts within the lender's knowledge that are material to the transaction if (i) the lender stands to benefit from the transaction at the borrower's expense and (ii) the facts known to the lender otherwise are not available to the borrower. Notably, the court reached this conclusion notwithstanding that a creditor normally has no fiduciary duty to its debtor and that, under applicable Florida law, a bank has a duty not to disclose information about a customer's account to a third party. Nevertheless, the *Barnett* court determined that a jury could weigh the competing duties of the lender.

Several courts, however, have held that there is no confidential relationship between a lender and its borrower that would justify liability on the part of the lender to the borrower.[30] For example, one court held that a lender had no special relationship to a borrower that considered becoming a guarantor on a preexisting loan, and thus, the bank would not be required to inform the guarantor it had classified the loan as a problem loan.[31]

"Good Faith" Dealing

Under the Uniform Commercial Code (UCC), "every contract or duty within [the UCC] imposes an obligation of good faith in its performance or enforcement."[32] One theory of

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[28] *Cent. States Stamping Co.*, 727 F.2d at 1409; *see also* Ziemba v. Cascade Int'l., Inc., 256 F.3d 1194, 1206 (11th Cir. 2001) ("Some of the factors that we consider in determining whether a duty to disclose exists include: the relationship between the plaintiff and defendant, the parties' relative access to the information to be disclosed, the benefit derived by the defendant from the purchase or sale, defendant's awareness of plaintiff's reliance on defendant in making its investment decision, and defendant's role in initiating the purchase or sale.") (internal quotations and citations omitted); First Va. Bankshares v. Benson, 559 F.2d 1307 (5th Cir.), *cert. denied*, 435 U.S. 952 (1978).

[29] 498 So. 2d 923 (Fla. 1986); *see also* Chain Tech. Inc. v. Fleet Nat'l Bank (*In re* Handy & Harmon Ref. Group, Inc.), 293 B.R. 299, 306 (Bankr. D. Conn. 2003) (recognizing that, under certain circumstances, a bank may have a duty to disclose information to customer that resulted in loss to that customer). *But see* United Jersey Bank v. Kensey, 704 A.2d 38, 46-47 (N.J. Super. Ct. 1997) (refusing to impute a duty to disclose absent "egregious breaches of the lender's duty of good faith and fair dealing").

[30] Centerre Bank v. Distributors, Inc., 705 S.W.2d 42, 53 (Mo. Ct. App. 1985); *see also* First Fed. Sav. Bank v. CPM Energy Sys. Corp., 1993 WL 138986, at*3 (Del. Super. Ct. Apr. 22, 1993); Delta Diversified, Inc. v. Citizens & S. Nat'l Bank, 320 S.E.2d 767 (Ga. Ct. App. 1984). *But see* Frame v. Boatmen's Bank, 824 S.W.2d 491, 494 (Mo. Ct. App. 1992) ("[S]ometimes an obligation to speak may arise; otherwise a lender may be guilty of negligent misrepresentation.").

[31] *See Centerre*, 705 S.W.2d at 53.

[32] U.C.C. § 1-203 (2001).

lender liability, albeit a limited one, is founded on the lender's breach of the duty to conduct its business with the borrower in "good faith."[33]

The seminal case that articulated a cause of action based on a lender's breach of an implied duty of good faith is *K.M.C. Co. v. Irving Trust Co*.[34] In *KMC*, the United States Court of Appeals for the Sixth Circuit upheld a judgment in favor of the borrower for damages arising from the lender's breach of the implied duty of "good faith and fair dealing" owed to the borrower with respect to the lender's performance under a financing agreement. The borrower had a $3,500,000 discretionary line of credit that was fully secured. The documents provided for repayment of the loan upon demand. The nature of the collateral (accounts receivable and inventory) was such that amounts outstanding under the line of credit would be paid down rapidly on demand. Quarterly audits showed that the lender would suffer no loss in the event of the borrower's liquidation. Nonetheless, without notice to the borrower, the lender's loan officer refused to advance funds sufficient to cover checks the borrower had written despite his previous consent to advance the funds. As a result, the borrower's checks were not paid and eventually the borrower went out of business. The trial court found, and the court of appeals affirmed, that the lender's actions were arbitrary, capricious, and in breach of its obligations of good faith dealing under the financing agreement.[35]

The holding in *KMC* that the good-faith requirement applies to a demand note has proved to be highly controversial. Indeed, the drafters of the UCC provision, which applies the general obligation of good faith specifically to a lender's right to accelerate payment at will, stated that "obviously th[e] section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason."[36] Consistent with this premise, courts generally have held that the good faith requirement does not apply to demand notes and have rejected this aspect of *KMC*.[37] Most state courts that have examined *KMC* have either rejected its holding entirely or limited its holding to the facts of the case.[38] Some have used particularly sharp language

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[33] *See*, *e.g.*, Jones Co. Custom Homes v. Commerce Bank, N.A., 116 S.W.3d 653 (Mo. Ct. App. 2003) (recognizing that Tennessee law requires that contracts be performed and enforced in good faith). *But see In re* Sunterra Corp., 298 B.R. 549, 553 (D. Md. 2003) (noting that Indiana law does not recognize an implied obligation of good faith in every contract).

[34] 757 F.2d 752 (6th Cir. 1985).

[35] *See* Windsor Shirt Co. v. N.J. Nat'l Bank, 793 F. Supp. 589 (E.D. Pa. 1992) (evidence sufficient to support cause of action against lender where lender had routinely waived technical defaults but demanded full payment one month before the due date), *aff 'd*, 989 F.2d 490 (3d Cir. 1993).

[36] U.C.C. § 1-208 official comment.

[37] *See*, *e.g.*, Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1357 (7th Cir. 1990); Nat'l Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 680 (S.D.N.Y. 1991), *aff'd sub nom.* Yaeger v. Nat'l Westminster Bank, 962 F.2d 1 (2d Cir. 1992); Needham v. The Provident Bank, 675 N.E.2d 514, 523 (Ohio App. 1996).

[38] *See*, *e.g.*, Waller v. Md. Nat'l Bank, 620 A.2d 381, 391 (Md. 1993); Gaul v. Olympia Fitness Ctr., Inc., 623 N.E.2d 1281, 1287 (Ohio Ct. App. 1993); Sw. Sav. & Loan Ass'n v. SunAmp Sys., Inc., 838 P.2d

in finding that good faith is not required of a party seeking to collect on a demand note. For example, in *Shawmut Bank, N.A. v. Miller*,[39] the payee of a note sought recovery of the balance due from the guarantors. In response, the guarantors claimed that the payee's demand violated the duty of good faith. After determining that the note was a demand note, the court held that there was no "good faith" obligation of the lender when exercising its right under the demand note:

> Not only is the balance due on a traditional demand note collectible without demand, but also a holder of such a note may determine to collect the balance due for any reason, good or bad. Good faith is not a condition of a holder's decision to collect the amount due on a demand note. . . . The official comment to § 1-208 makes clear that § 1-208 was not intended to apply to demand notes.[40]

On the other hand, some courts have construed demand notes strictly, limiting the exception to the good faith requirement to "pure" demand notes.[41] Similarly, if under the terms of the note, some form of demand for payment must be made, some courts have held that the lender must act in good faith in making that demand.[42]

In *Reid v. Key Bank*,[43] the United States Court of Appeals for the First Circuit upheld a grant of damages to a borrower for a lender's breach of the UCC duty of good

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1314, 1322 (Ariz. Ct. App. 1992); Check Reporting Servs., Inc. v. Mich. Nat'l Bank, 478 N.W.2d 893, 899 (Mich. Ct. App. 1991); Creeger Brick & Bldg. Supply, Inc. v. Mid-State Bank & Trust Co., 560 A.2d 151, 154 (Pa. Super. Ct. 1989); Pavco Indus. v. First Nat'l Bank, 534 So. 2d 572, 577 (Ala. 1988); Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336, 1341 (Fla. Dist. Ct. App. 1986); Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 953 (Mo. Ct. App. 1986).

[39] 614 N.E.2d 668 (Mass. 1993).

[40] *Id.* at 669-70 (citations omitted); *see also* Mirax Chem. Prods. Corp. v. First Interstate Commercial Corp., 950 F.2d 566, 570, n.9 (8th Cir. 1991) ("[U.C.C. § 1-203] has no application to demand instruments or obligations whose very nature permits call at any time or without reason"); Solar Motors, Inc. v. First Nat'l Bank, 545 N.W.2d 714, 720 (Neb. 1996) ("[n]o obligation of good faith and fair dealing is imposed on a party calling a demand note"); Henning Constr., Inc. v. First E. Bank & Trust Co., 635 So. 2d 273, 275 (La. Ct. App.) ("there is no duty of good faith associated with a demand note"), *writ denied*, 642 So. 2d 870 (La. 1994).

[41] *See, e.g.*, Bank One, Tex., N.A. v. Taylor, 970 F.2d 16 (5th Cir. 1992) (holding bank had good-faith obligation because note and security agreement contained acceleration clause and specific events of default that made it appear as if obligation truly was not due on demand), *cert. denied*, 508 U.S. 906 (1993); *see also* Iraola & CIA, S.A. v. Kimberly-Clark Corp., 325 F.3d 1274, 1281 (11th Cir. 2003); Reid v. Key Bank, 821 F.2d 9 (1st Cir. 1987); Coffee v. Gen. Motors Acceptance Corp., 5 F. Supp. 2d 1365, 1376 (S.D. Ga. 1998).

[42] *See* Reid v. Key Bank, 821 F.2d 9, 13-14 (1st Cir. 1987) (refusing to read a demand clause literally, and therefore, implying a good faith obligation). *But see* Renaissance Yacht Co., Inc. v. Stenbeck, 818 F. Supp. 407, 408 (D. Me. 1993) (recognizing that, in interpreting Maine's Uniform Commercial Code, *Reid's* prediction of how Maine courts would rule proved inaccurate).

[43] 821 F.2d 9 (1st Cir. 1987).

faith dealing. In *Reid*, the borrower and the lender, which had a prior three-year lending relationship, entered into a line of credit that could be terminated at will by the lender. Within two months, the lender terminated the line of credit without notice notwithstanding that the borrower was not in default and had experienced no material change in financial position. The lender made no effort to negotiate alternative solutions to whatever problems it perceived in its lending relationship with the borrower. On this evidence, the court of appeals held that there was sufficient basis for the jury's finding the lender had acted in bad faith in making the demand for payment without prior notice.

A trend has emerged, however, rejecting allegations of breach of the duty of good-faith dealing where a lender simply complies with the terms of its agreement with the borrower.[44] Notably, in *East Lansing State Bank v. Red Cedar Construction Co. (In re Red Cedar Construction Co.)*,[45] the court concluded that *KMC* stands for the proposition that a lender in good faith must give prior notice to a borrower of the lender's decision not to advance additional funds. The court held, however, that this notice obligation is necessary only where there is an enforceable loan agreement and the lender has reason to believe that the borrower is creditworthy or otherwise capable of payment. The court stated that a "notice requirement which is intended to give the borrower sufficient time to secure alternate financing is meaningless for a borrower who could not demonstrate objective creditworthiness."[46] The court distinguished *KMC* by noting that in the case before it there was no evidence that the lender ever committed to make the loan sued on and there was evidence of the borrower's serious financial distress.[47]

The United States Court of Appeals for the Seventh Circuit also has refused to hold a lender liable for violating the duty of good faith when the lender's actions were expressly permitted by the loan agreement. In *Continental Bank, N.A. v. Everett*,[48] a bank loaned a television broadcasting company $4,200,000, payment of which was guaranteed

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[44] *See* Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351, 1358 (7th Cir. 1990) ("To the extent [*KMC*] holds that a bank must loan more money or give more advance notice of termination than its contract requires, we respectfully disagree."); SI Commc'ns, Inc. v. Nielsen Media Research, 181 F. Supp. 2d 404, 410 (S.D.N.Y. 2002) (implied duty of good faith does not negate explicit provisions of an agreement); Westinghouse Elec. Corp. v. McLean, 938 F. Supp. 487, 494 (N.D. Ill. 1996) (lender not liable for failing to disburse additional funds to borrower because credit agreement provided that disbursements of funds by lender would be discretionary); Nat'l Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 680 (S.D.N.Y. 1991), *aff'd sub nom.* Yaeger v. Nat'l Westminster, 962 F.2d 1 (2d Cir. 1992) ("this Court declines to follow *KMC* to the extent that the obligation of good faith performance enunciated there would imply an obligation of good faith upon the Bank inconsistent with the express terms of its contractual relationship"); In re Lois/USA, Inc., 264 B.R. 69, 124 (Bankr. S.D.N.Y. 2001) (implied duties do not abrogate express contractual provisions); *see also* Charles E. Brauer Co. v. NationsBank of Va., N.A., 466 S.E.2d 382 (Va. 1996) (there is no independent tort for breach of duty of good faith).

[45] 63 B.R. 228 (Bankr. W.D. Mich. 1986).

[46] *Id.* at 238.

[47] *Id.*

[48] 964 F.2d 701 (7th Cir.), *cert. denied*, 506 U.S. 1035 (1992).

by the borrowing company's stockholders. The borrower filed for chapter 11 protection, and ultimately, confirmed a plan of reorganization pursuant to which it satisfied in full the principal amount of its loan and all accrued nonpenalty interest. The borrower did not, however, pay the penalty interest. Accordingly, the bank sought from the guarantors payment of the penalty interest as well as its legal fees.

The guarantors contended that the bank had left the loan undersecured, thereby exposing the guarantors to greater risk than they had expected. Specifically, they asserted that the bank had breached its duty of good faith by failing to disclose that it had not obtained a security interest in the borrower's broadcasting license and by neglecting to perfect its security interest in the borrower's leaseholds.

Stating that "[i]n the end the parties' rights are fixed by their contracts,"[49] the court rejected the guarantors' arguments and identified several "dispositive provisions" in the contracts. One such provision stated that the security was for the benefit of the bank, not the borrower or the guarantors. Another provision stated that the bank had no duty with respect to the collateral other than to provide safe custody of any collateral actually in the bank's possession. Moreover, by signing the contract, the guarantors expressly had waived all diligence in collection or protection of, or realization on, any security for the loan.

The court held that the duty of good faith did not require the bank to conduct itself in a fashion contrary to what the parties agreed by contract. According to the court, "good faith is another way to describe the effort to devise terms to fill contractual gaps [and] has little to do with the formation of contracts...and [has] nothing to do with the enforcement of terms actually negotiated."[50] Accordingly, because the guarantors and the bank had negotiated and agreed to provisions establishing specifically what duties the bank would (and would not) have regarding security, the guarantors' good faith argument was unsuccessful. As the court concluded, "[g]ap-filling methods such as good faith do not 'block use of terms that actually appear in the contract.' The guarantors released [the bank] from any obligation to use the collateral for their benefit. The guarantors may rue their decision but cannot escape it."[51]

Although a lender's lack of good faith in the enforcement of its remedies may not give rise to liability, some courts have held that a lender that fails to *negotiate* the terms of a loan agreement in good faith may be liable to the borrower for breach of contract.[52] Generally, these courts have found that when parties enter into a binding loan commitment, they accept a mutual commitment to negotiate together in good faith in an

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[49] *Id.* at 704.

[50] *Id.* at 705.

[51] *Id.* (citation omitted).

[52] *See, e.g.*, Int'l Minerals & Mining Corp. v. Citicorp N. Am., Inc., 736 F. Supp. 587 (D.N.J. 1990); Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987).

effort to reach final agreement within the scope that has been settled in the preliminary agreement.

Conversely, other courts have noted that while lenders have a duty to act in good faith in the performance and enforcement of their contracts, they do not necessarily owe a duty of good faith and fair dealing in the negotiation of contract terms.[53] For instance, in *Continental Bank, N.A. v. Modansky*,[54] the court held that a lender had no duty to disclose the risks associated with a particular loan when negotiating guarantees of that loan.

In *Continental*, four lumber company affiliates obtained a $15,000,000 loan guaranteed by their parent company and by two shareholders who collectively held a majority of the parent company's stock. Less than one year later, the parties executed an agreement providing for a $4,000,000 supplemental loan, also guaranteed by the shareholders. On the supplemental loan's expiration date, the parties executed an amendment extending the $4,000,000 loan for another forty-five days. At the end of that forty-five day period, the supplemental loan expired, and because some of the letters of credit issued thereunder were outstanding, their undrawn amounts were added to the outstanding debt balance on the original $15,000,000 loan.

At the time of expiration, two of the lumber companies became insolvent and eventually were liquidated. The bank declared a default on the $15,000,000 loan, causing the outstanding balance to become due and payable. The bank received the lumber companies' liquidation proceeds, but claiming that it was still owed more than $4,000,000, called on the guarantors to pay the remaining balance. The guarantors refused to pay these amounts, arguing that they were excused from their obligation to pay because the bank had breached its duty of good faith and fair dealing.

The guarantors first alleged that the bank violated its duty of good faith by terminating the additional $4,000,000 loan at the end of the forty-five day extension period. The court dismissed this allegation, holding that the expiration date was explicit in the credit agreement, and therefore, was a contract term. According to the court, the execution of the contract evidenced the lumber companies' acceptance of that term. Moreover, because the material terms of the extension were set forth in the loan

[53] *See*, *e.g.*, Rosemont Gardens Funeral Chapel-Cemetary, Inc. v. Trustmark Nat'l Bank, 330 F. Supp. 2d 801, 811 (S.D. Miss. 2004) ("A number of courts have implicitly recognized, in fact, that a duty of good faith and fair dealing does not arise even where a lender begins negotiations towards restructuring an existing loan."); Mark Andrew of Palm Beaches, Ltd. v. GMAC Commercial Mortgage Corp., 265 F. Supp. 2d 366, 383 (S.D.N.Y. 2003) (there is no obligation of good faith unless an agreement has been reached, whether it be a preliminary agreement or actual contract), *aff'd*, No. 03-7801, 2004 WL 860161 (2d Cir. Apr. 22, 2004); Village on Canon v. Bankers Trust Co., 920 F. Supp. 520, 535 (S.D.N.Y. 1996); Hodge v. First Nat'l Bank, No. CA 93-627, 1994 WL 188860 (Ark. Ct. App. May 4, 1994) ("We agree with appellee that the implied duty of good faith stems only from contractual obligations and does not extend to pre-contractual negotiations.") (citation omitted).

[54] 997 F.2d 309 (7th Cir. 1993).

agreement, the bank "did not owe the lumber companies a duty of good faith and fair dealing in the negotiation of the contract terms."[55]

Next, the guarantors claimed that the bank acted in bad faith by failing to inform them sufficiently of the risks associated with the additional guaranties. Again, however, the court held that the bank's duty of good faith "arises in the performance, not in the negotiation, of the additional [loan] agreements."[56] Moreover, "[o]nly an express contractual duty or a fiduciary relationship would [have] require[d the bank] to speak about the possible consequences of securing the additional credit."[57]

Finally, the guarantors argued that the bank caused the lumber companies' liquidation and consequent default on the $15,000,000 loan by forcing the premature closing of the insolvent companies. The court concluded, however, that even if the bank did threaten to call the loan due, that act did not violate the bank's duty of good faith as a matter of law. Relying on a decision of the Illinois Supreme Court,[58] the court held that "when a creditor acts honestly when activating guaranties and utilizing insecurity clauses, the creditor does not violate the duty of good faith *even if such actions are not reasonable*."[59] The bank claimed that it honestly believed that it would not be repaid the money it was owed. Because the guarantors did not prove otherwise, the court found that although the bank's threats to call the loan due if the insolvent lumber companies were not closed may have been unreasonable, they were made in good faith.

Although generally lenders are shielded from liability for breach of good faith if they act in accordance with their contract terms, at least one court has held that they may be liable nevertheless if they exercise rights granted to them by the express terms of their contract without a good-faith reason for doing so.[60] In *Duffield v. First Interstate Bank*, an individual borrowed $2,000,000 from a bank initially on an unsecured basis. The borrower subsequently granted the bank a security interest in various gas and oil wells pursuant to a mortgage, which contained an assignment-of-payments clause.

Following the death of his daughter, the borrower became delinquent in his monthly loan payments. The borrower's office manager, who supervised the borrower's

[55] *Id.* at 312.

[56] *Id.* at 313.

[57] *Id.*

[58] Watseka First Nat'l Bank v. Ruda, 552 N.E.2d 775 (Ill. 1990).

[59] 997 F.2d at 313 (emphasis added).

[60] *See* Duffield v. First Interstate Bank, 13 F.3d 1403 (10th Cir. 1993); *accord* Mike Naughton Ford, Inc. v. Ford Motor Co., 862 F. Supp. 264, 272 (D. Colo. 1994) (the duty of good faith and fair dealing requires that parties perform their obligations under contracts in good faith, even if the contractual obligations are unambiguous); Tufankjian v. Rockland Trust Co., 782 N.E.2d 1, 5 (Mass. App. Ct. 2003) ("Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.") (internal quotations and citations omitted).

business affairs during the borrower’s period of bereavement, informed the bank that the borrower had agreed to sell one of his properties in order to rectify the delinquency. The bank’s vice president apprised the manager that the release value of the property to be sold was $382,000.

Although denied by the bank, the borrower’s manager claimed the bank orally agreed that in exchange for $450,000 it would release the property, catch up the delinquent payments, and prepay one or two months so that the borrower would be relieved of the pressures of his business affairs while in mourning. However, as a result of the bank having applied the funds to principal in inverse order of maturity, the borrower remained delinquent in his payments on the loan, and consequently, the bank exercised a right of assignment provided for in the mortgage by requesting that the operators of the borrower’s wells send all proceeds directly to the bank. As a result of the bank’s actions, the borrower’s credit was damaged and his interests in the wells were extinguished.

The borrower brought suit against the bank, asserting, among other things, that it breached the covenant of good faith. The bank alleged that its exercise of the assignment was justified by the borrower’s delinquency on his loan payments. The United States Court of Appeals for the Tenth Circuit held that under applicable Colorado law, even where the express terms of a contractual provision appear to permit unreasonable actions, “the implied duty of good faith and fair dealing limit[s] the parties’ ability to act unreasonably in contravention of the other party’s reasonable expectations.”[61] More specifically, the court reiterated its prior holding in *Big Horn Coal Co. v. Commonwealth Edison Co.*,[62] that “‘where a contract provision is exercisable only at some discretion of one of the parties, and expectations are created by the contract, good faith limitations are applicable to protect the non-exercising party from unexpected invocation of the option.’”[63]

By holding that the bank breached its duty of good faith, it appears that the *Duffield* court not only followed *Big Horn Coal Co.,* but expanded its scope. In *Big Horn Coal Co.,* the court had held that the offended party’s expectations had to be created “by the contract.” In *Duffield*, however, the court held that the bank had violated the duty of good faith because “the proper interpretation of the agreement *and its surrounding circumstances* mandate[d] the conclusion that the agreed common purpose of the loan and security agreements was to permit [the borrower] to repay the loan within its terms through the continued operation of his business.”[64]

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[61] *Id.* at 1405-06.

[62] 852 F.2d 1259 (10th Cir. 1988).

[63] *Duffield*, 13 F.3d at 1406 (quoting *Big Horn Coal Co.*, 852 F.2d at 1269 n.15).

[64] *Id.* (emphasis added).

In other words, *Duffield* broadens the inquiry beyond the terms of the contract and invites an examination of a lender's course of conduct to determine whether the lender breached its duty of good faith in exercising that right. Thus, in *Duffield*, by permitting the borrower to keep and sell the oil during the first four months in which his payments were late, the lender created a reasonable expectation that the borrower could continue to do so absent any future default. This expectation was reinforced by an officer of the bank, who led the borrower to believe that the *status quo* would be maintained if the designated property was sold and the proceeds were paid to the bank. Indeed, through its actions, "[t]he Bank created a reasonable expectation in [the borrower] that the assignment provision would not be used absent a good reason and an adequate chance to cure so that the basic structure of the loan would not be frustrated."[65] Accordingly, *Duffield* affirmed the holding of the district court that the bank had breached the implied covenant of good faith.

As *Duffield* illustrates, lenders may be held liable if they *unexpectedly* exercise a contractual right under circumstances where prior actions created a reasonable expectation that this right would only be used in a "reasonable" fashion, even though a lender generally may avoid liability by not deviating from the express terms of its contracts.[66]

WAIVER OR ESTOPPEL

Related to the "good faith" cases are the decisions in which lenders are held to have waived, or held to be estopped from exercising, rights and remedies under their loan agreements.[67] For example, in *Ford Motor Credit Co. v. Waters*,[68] the borrower, an automobile purchaser under a purchase-money installment contract, sued the lender/seller for damages due to wrongful repossession. The borrower was two months behind on its payments, but had made more than half the payments required under the contract. Throughout the course of the contract, the lender routinely had accepted late payments from the borrower. Affirming the trial court's award of damages to the borrower, the *Waters* court held that the lender/seller had waived its right to repossess the automobile based on the lender/seller's past practice of accepting late payment:

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[65] *Id.*

[66] However, if a lender is held liable to a borrower on some other legal theory, a court may refuse to hold the lender also liable to the borrower for breach of the duty of good faith. *See In re* Clemens, 197 B.R. 779, 798 (Bankr. M.D. Pa. 1996), *vacated in part*, 225 F.3d 648 (3d Cir. 2000).

[67] *See, e.g.*, Westinghouse Credit Corp. v. Shelton, 645 F.2d 869, 874 (10th Cir. 1981) ("Absent an 'anti-waiver' clause . . . courts have uniformly held that a creditor may not fall into a pattern of accepting delinquent installments and then suddenly declare default, without first apprising the debtor of his insistence on strict compliance with the terms of the contract.") (citations omitted); Tillquist v. Ford Motor Credit Co., 714 F. Supp. 607, 611 (D. Conn. 1989) (recognizing split in authority regarding whether a lender can waive rights if contract contains antiwaiver provisions).

[68] 273 So. 2d 96 (Fla. Dist. Ct. App. 1973).

> The facts before us adequately set up a pattern of conduct that would lead the [borrower] to believe that late payments would be accepted by the [lender] and that he would be allowed to catch up in his payment arrears. Notification of a change in this pattern should have been given to [the borrower] by [the lender] prior to repossession of the automobile.[69]

Accordingly, like *Duffield*, this case reinforces the principle that a lender's prior course of conduct affects whether future actions may lead to the imposition of lender liability.

SOME LESSONS FOR LENDERS

The "good faith" cases discussed above are illustrative of several important principles of lender liability:

- the establishment of a course of dealing in which late payments are routinely accepted may rebound to the detriment of a lender, notwithstanding what the documents may provide;[70]
- a lender should not take lightly its contractual obligation to make advances or financing available;
- in the cases in which the lender was not held to be acting in bad faith when it limited financing, called a note, or repossessed collateral without notice, the lender was acting within the express terms of its agreement with the borrower; nevertheless, lenders should be careful to act reasonably, even when taking actions expressly permitted by such an agreement; and to limit or avoid both unwarranted borrower expectations and potential liability, the lender should act in a consistent manner and in accordance with its documents, or if it does not and does not want that variance to bind it in the future, the lender should so advise the borrower contemporaneously in writing.

EQUITABLE SUBORDINATION

Another serious risk for a lender dealing with a failing borrower is the chance that the lender's claim may be equitably subordinated to the claims of other creditors in a chapter 11 reorganization case, chapter 7 liquidation case, or state law proceeding involving the liquidation and distribution of the borrower's assets.

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[69] *Id.* at 100.

[70] *See* Sahadi v. Cont'l Ill. Nat'l Bank & Trust Co., 706 F.2d 193, 197 (7th Cir. 1983) (holding there was an issue of fact as to whether bank's calling a loan was in good faith where, among other things, bank had "clear knowledge that [the debtor] had on hand in the Bank, and tendered, funds sufficient to satisfy the interest requirement; the Bank had previously accepted late payments in its course of dealings with [the debtor]; and there was evidence that calling a loan for such a brief delay [of less than one day] was without precedent in the banking community").

Specifically, § 510(c) of the Bankruptcy Code authorizes the bankruptcy court to, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim [or equity interest] to all or part of another allowed claim [or equity interest]," as the case may be, and to "order that any lien securing such a subordinated claim be transferred to the estate."[71] Equitable subordination of a claim "moves the creditor down in the order of payment out of the assets in the bankruptcy estate, generally reducing (or eliminating) the amount the creditor can recover."[72]

Whether a court will order the equitable subordination of a lender's claim or interest is highly fact-dependent and will vary from case to case. Generally, however, a court will equitably subordinate a lender's claims when it concludes that the lender engaged in fraud or other grossly inequitable conduct that resulted in harm to other creditors of the borrower. The leading case, *Benjamin v. Diamond (In re Mobile Steel Co.)*,[73] set forth the following three requirements for equitable subordination to be an appropriate remedy in a bankruptcy case:

> (i) The claimant must have engaged in some type of inequitable conduct.
>
> (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant.
>
> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.[74]

[71] The source of the bankruptcy court's power to subordinate claims is the court's "general equitable power to adjust equities among creditors in relation to the liquidation results." 80 Nassau Assocs. v. Crossland Fed. Savs. Bank (*In re* 80 Nassau Assocs.), 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994). The equitable goal to prevent injustice or unfairness in the bankruptcy context is accomplished by permitting the court to subordinate an otherwise legally valid claim when the claimant has engaged in conduct that makes it unjust or unfair for the claimant to share *pro rata* with similarly situated creditors. *Id.*

[72] *In re* Lifschultz Fast Freight, 132 F.3d 339, 341 (7th Cir. 1997).

[73] 563 F.2d 692 (5th Cir. 1977), *cited with approval in* United States v. Noland, 517 U.S. 535, 539 (1996) ("The district courts and courts of appeals have generally followed the Mobile Steel formulation."); *see also* Merrimac Paper Co. v. Harrison (*In re* Merrimac Paper Co.), 420 F.3d 53 (1st Cir. 2005) (adopting *Mobile Steel* as "the gold standard for section 510(c) cases").

[74] 563 F.2d at 700 (citations omitted). The last requirement is simply "a reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives that the result is inequitable." *Noland*, 517 U.S. at 539. Furthermore, because this equitable subordination test was formulated before the enactment of the Bankruptcy Reform Act of 1978, the third prong is likely moot due to the enactment of Bankruptcy Code § 510(c). *See* Official Comm. of Unsecured Creditors v. Austin Fin. Serv., Inc. (*In re* KDI Holdings, Inc.), 277 B.R. 493, 509 (Bankr. S.D.N.Y. 1999); *see, e.g.*, Jeremy W. Dickens, Note, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control,"* 65 TEX. L. REV. 810, 814 n.74 (1987).

INEQUITABLE CONDUCT

Identifying inequitable conduct is "the critical inquiry" in equitable subordination cases."[75] Inequitable conduct for the purposes of equitable subordination of a claim is commonly defined as (i) fraud, illegality, or breach of fiduciary duty, (ii)

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[75] *See* Sender v. Bronze Group, Ltd. (*In re* Hedged-Investments Assocs.), 380 F.3d 1292, 1300 (10th Cir. 2004). Outside the lender context, however, proof of inequitable or egregious conduct may not be required to subordinate certain claims. In *In re* Virtual Network Servs. Corp., 902 F.2d 1246 (7th Cir. 1990), the Court of Appeals for the Seventh Circuit concluded that, in principle, equitable subordination no longer required inequitable conduct on the part of the creditor in all circumstances. The creditor in that case, the IRS, had asserted a claim against the debtor for a nonpecuniary loss — i.e., a tax penalty. The focus of the court was not on the conduct of the IRS but on fairness to other creditors in the particular case if the claims of the IRS were paid pro rata with general unsecured claims. The court determined that punishing the innocent creditors of the debtor because of the debtor's wrongful conduct (failure to file tax returns) would serve no purpose and that it would be unfair for the court to shift the burden of the IRS's penalty claim, which was punitive in nature, to innocent creditors. Rather, the court held that in the interest of fairness, the unsecured creditors with actual losses in the case were entitled to have the nonpecuniary-loss claim of the IRS equitably subordinated. Several other courts have adopted the reasoning of *Virtual Network* in the context of nonpecuniary-loss tax penalties. *See* Burden v. United States, 917 F.2d 115 (3d Cir. 1990); Schultz Broadway Inn v. United States, 912 F.2d 230 (8th Cir. 1990); *In re* Manchester Lakes Assocs., 117 B.R. 221 (Bankr. E.D. Va. 1990).

The United States Supreme Court has issued two opinions that appear to narrow the holding of *Virtual Network* and its progeny to nonpecuniary-loss claims. In United States v. Noland, 517 U.S. 535 (1996), the Supreme Court expressly declined to decide "whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated," but reversed the Sixth Circuit's decision affirming a bankruptcy court's subordination of an IRS claim for a postpetition, noncompensatory tax penalty (which normally would receive a priority in bankruptcy as an administrative expense, *see* 11 U.S.C. §§ 503(b)(1)(C), 507(a)(2)). The Supreme Court deemed the lower court's application of the principles of equitable subordination "inappropriately categorical in nature." 517 U.S. at 543. In United States v. Reorganized CF&I Fabricators, 518 U.S. 213 (1996), the Supreme Court reiterated and expanded its holding in *Noland:* "The principle is simply that categorical reordering of priorities that takes place at the legislative level of consideration is beyond the scope of judicial authority to order equitable subordination under § 510(c)." *Id.* at 229.

Thus, although the Supreme Court has stated that absent inequitable conduct, equitable subordination of claims on a categorical basis is improper, it has expressly declined to decide whether creditor misconduct is a prerequisite to equitable subordination. *See, e.g., In re* Hospitality Assocs., 212 B.R. 188, 190 (Bankr. D.N.H. 1997) (discussing *Noland*). More recently, however, the Court of Appeals for the Seventh Circuit (which decided *Virtual Network*) limited *Virtual Network* to "a class of tardy tax penalties" and reaffirmed the general requirement of creditor misconduct for purposes of equitable subordination when it found that the making of a loan to an allegedly undercapitalized borrower did not alone constitute inequitable conduct. *In re* Lifschultz Fast Freight, 132 F.3d 339, 347-48 (7th Cir. 1997). The Court of Appeals for the Tenth Circuit (which decided *CF&I Fabricators*) recently also "decline[d] to extend the 'no-fault' equitable subordination exception applied in CF&I Fabricators beyond the tax penalty context [and] adhere[d] to the general rule . . . that equitable subordination is not justified absent a finding that the party sought to be subordinated engaged in inequitable conduct." *Hedged-Invs. Assocs.*, 380 F.3d at 1301.

undercapitalization, or (iii) control or use of the debtor as an alter ego for the benefit of the claimant.[76]

As a general proposition, parties that seek to subordinate the claims of noninsiders of the debtor must demonstrate a more severe level of misconduct than would be required to justify the subordination of claims of insiders or fiduciaries.[77] In the bankruptcy context, an "insider" includes a "person [including a corporation or partnership] in control" of a debtor corporation or partnership.[78] The misconduct necessary to justify the subordination of claims of noninsiders has been described as "more egregious conduct"[79] than the "inequitable" conduct necessary to justify the subordination of insiders' claims.[80] Nonetheless, a creditor that is not a fiduciary or insider of the debtor may be treated as a fiduciary, and thereby held to the lesser "inequitable conduct" standard for equitable subordination, if such creditor exerts control over the debtor to the detriment of other creditors.[81] Thus, the extent to which a lender exercises control over a failing borrower is

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[76] *See, e.g., Hedged-Invs. Assocs.*, 380 F.3d at 1301; *Lifschultz Fast Freight*, 132 F.3d at 344-45; *Fabricators, Inc. v. Technical Fabricators, Inc.* (*In re* Fabricators, Inc.), 926 F.2d 1458, 1467 (5th Cir. 1991).

[77] *See, e.g., Hedged-Investments Assocs.*, 380 F.3d at 1302; Carter-Waters Okla., Inc. v. Bank One Trust Co., N.A. (*In re* Eufaula Indus. Auth.), 266 B.R. 483, 489 (B.A.P. 10th Cir. 2001); First Nat'l Bank v. Rafoth (*In re* Baker & Getty Fin. Serv., Inc.), 974 F.2d 712, 718 (6th Cir. 1992).

[78] *See* 11 U.S.C. § 101(31); *see* also *KDI Holdings, Inc.*, 277 B.R. at 511 ("'Although the Bankruptcy Code defines the term insider,' 11 U.S.C. § 101(31), courts have uniformly held that the Bankruptcy Code's definition is merely illustrative and that the term 'insider' must be flexibly applied on a case-by-case basis.' Pan Am Corp. v. Delta Air Lines, Inc., 175 B.R. 438, 398 (S.D.N.Y. 1994) (citations omitted). The legislative history of § 101(31) indicates that the term applies to 'one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms length with the debtor.' *Id.* (quoting S. Rep. No. 989, 95th Cong., 1st Sess. 25 (1978) . . . .)").

[79] *Hedged-Invs. Assocs.*, 380 F.3d at 1301 (10th Cir. 2004); Bayer Corp. v. Mascotech, Inc. (*In re* Autostyle Plastics, Inc.), 269 F.3d 726, 745 (6th Cir. 2001); Bank of N.Y. v. Epic Resorts-Palm Springs Marquis Villas, LLC (*In re* Epic Capital Corp.), 307 B.R. 767, 772 (D. Del. 2004); 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (*In re* 80 Nassau Assocs.), 169 B.R. 832, 840 (Bankr. S.D.N.Y. 1994) ("[U]nless the creditor has dominated or controlled the debtor to gain an unfair advantage, his claim will be subordinated, based on inequitable conduct, only if the claimant has committed some breach of an existing legally recognized duty.").

[80] *Hedged-Invs. Assocs.*, 380 F.3d at 1301-02; *In re* Autostyle Plastics, Inc., 269 F.3d at 745; *Epic Capital Corp.*, 307 B.R. at 772; Waslow v. MNC Commercial Corp. (*In re* M. Paolella & Sons, Inc.), 161 B.R. 107, 119 (E.D. Pa. 1993), *aff'd*, 37 F.3d 1487 (3d Cir. 1994).

[81] *See* Herzog v. Leighton Holdings, Ltd. (*In re* Kids Creek Partners, L.P.), 200 B.R. 996, 1015-16 (Bankr. N.D. Ill. 1996) (explaining there are "two types of control: 'de jure' control and 'de facto' control" and reasoning that a lender usurping the power of the debtor's directors and officers to make business decisions must also undertake the fiduciary obligation that the officers and directors owe the corporation and its creditors"). *But see M. Paolella & Sons*, 161 B.R. at 119 ("Equitable subordination has seldom been invoked, much less successfully so, in cases involving non-insiders and/or non-fiduciaries. As Judge Easterbrook pointed out in Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F. 2d 1351, 1356 (7th Cir. 1990), 'cases subordinating the claims of creditors that dealt at arms length with the debtor are few and far between.' The dearth of cases subordinating the claims of non-insiders is readily explained by the high threshold of misconduct that must be established by the objectant in non-insider cases.").

of special concern to a lender in preventing and defending against a claim of equitable subordination.

There is no clear definition of what constitutes a creditor's control over its borrower.[82] Rather, the analysis is fact intensive and depends on the circumstances of an individual case. In determining the issue of "control," courts have considered a number of factors, including: (1) control over the debtor's voting stock, (2) managerial control, including personnel decisions and decisions as to which creditors should be paid, (3) whether the relationship between the debtor and lender was the result of an arms-length transaction, and (4) whether the lender is the debtor's sole source of credit.[83] To establish domination and control by a lender, the allegations must indicate something more than a monitoring of a debtor's operations and proffering advice to management, even where the lender threatens to withhold future loans should the advice not be taken.[84]

The level of control that a lender must assert over its borrower to justify equitable subordination was discussed in *Berguist v. First National Bank (In re American Lumber Co.).*[85] In that case, the bankruptcy court specifically found that because of the lender's control over the borrower's operations, it had a duty to deal fairly and impartially with the borrower and its other unsecured creditors. The bankruptcy court found that the lender breached that duty by undertaking a course of liquidation that was designed solely to enhance its security interests and contract rights and to preempt recoveries to general unsecured creditors. The district court found that the evidence of the lender's control was overwhelming. When the borrower defaulted, the lender had the right to a controlling interest in the borrower's stock. The lender foreclosed on its security interests in accounts receivable and contract rights, depriving the borrower of its sole source of cash.[86] The lender then forced the borrower to accept austerity measures, forced the

[82] *See* Austin v. Chisick (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 667 (C.D. Cal. 2003) (citing *80 Nassau Assocs.*, 169 B.R. at 837).

[83] *See* Berguist v. First Nat'l Bank (*In re* Am. Lumber Co.), 5 B.R. 470, 477 (D. Minn. 1980); *In re* Process-Manz Press, Inc., 236 F. Supp. 333, 348 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966)); *KDI Holdings, Inc.*, 277 B.R. at 510-11 (collecting cases and citing Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe and Supply Co.), 893 F.2d 693, 700 (5th Cir. 1990)); Anaconda-Ericsson, Inc. v. Hessen (*In re* Teltronics Servs., Inc.), 29 B.R. 139, 171 (Bankr. E.D.N.Y. 1983).

[84] *See* Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 610 (2d. Cir.) ("In order to establish their claims the appellants must show not simply that the banks proffered advice to [the debtor] that was unpalatable to management, even advice gloved with an implicit threat that, unless taken, further loans would not be forthcoming. They must show at least that the banks acted solely for their own benefit . . . and adversely to the interest of others."), *cert. denied*, 464 U.S. 822 (1983), *cited in KDI Holdings, Inc.*, 277 B.R. at 511; *see also In re* Autostyle Plastics, Inc., 269 F.3d at 745 ("While we apply careful scrutiny in our review of an equitable subordination claim involving an insider, we use great caution in applying the remedy: 'equitable subordination is an unusual remedy which should be applied in limited circumstances.' This general language applies to claims involving both insiders and non-insiders.") (citations omitted).

[85] 5 B.R. 470 (D. Minn. 1980).

[86] The lender was the borrower's sole source of credit and the borrower's decision not to honor the borrower's payroll checks placed the borrower within the "coercive power" of the lender.

termination of all employees, allowing only those necessary for liquidation, cut the borrower's officer's salaries to one-sixth of their original amount, determined which creditors would be paid and which would not, and required the borrower to execute additional security agreements in favor of the lender, pledging all the borrower's remaining assets. The district court affirmed the bankruptcy court's judgment equitably subordinating the lender's claim.

The level of control that a lender must assert over its borrower to justify equitable subordination also was discussed in *Anaconda-Ericsson, Inc. v. Hessen (In re Teltronics Services, Inc.*)[87] The bankruptcy court in that case stated "that a non-insider creditor will be held to a fiduciary standard only where his ability to command the debtor's obedience to his policy directives is so overwhelming that there has been, to some extent, a merger of identity. Unless the creditor has become, in effect, the *alter ego* of the debtor, he will not be held to an ethical duty in excess of the morals of the marketplace."[88] Despite its finings that the lender restricted outside financing, monitored the borrower's finances, and made recommendations on the borrower's business decisions, the bankruptcy court found that the lender's relationship with the borrower "did not transcend that of debtor and creditor, and that [the lender] should not be held to a fiduciary standard."[89] Thus, the court found, "it was incumbent upon the trustee to demonstrate . . . very substantial misconduct tantamount to fraud, overreaching or spoliation, which caused other creditors . . . to suffer damages." Based on the facts of the case, the court found that the trustee's case fell short of "establishing such egregious conduct as would justify equitable subordination of the claim of a non-insider."[90]

Comparing *American Lumber* and *Teltronics*, the court in *Bank of New Richmond v. Production Credit Ass'n (In re Osborne)* concluded "a creditor must exercise virtually complete control to be treated as a fiduciary."[91] The bankruptcy court in *Osborne* had found that one creditor (PCA) had engaged in "inequitable conduct," which resulted in injury to three other creditors (the Bank, Cenex, and General). Based on that finding, the bankruptcy court ordered that PCA's claim be subordinated to the claims of the Bank, Cenex, and General. The bankruptcy court made no findings that PCA had control over the debtors, however. The bankruptcy court had found that PCA's relationship with the debtors "approach[ed] the status of a joint venture," that PCA's loan to the debtors was a "controlled loan" and that PCA gave directions on how to spend loan funds. The bankruptcy court had further found that PCA had considerable power over the debtors as a result of PCA's security interest in most of the debtors' assets. The bankruptcy court,

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[87] 29 B.R. 139 (Bankr. E.D.N.Y. 1983).

[88] *Id.* at 171, *cited in KDI Holdings, Inc.*, 277 B.R. at 512.

[89] *Id.* at 171-72.

[90] *Id.* at 173.

[91] 42 B.R. 988, 997 (W.D. Wis. 1984), *cited in* Waslow v. MNC Commercial Corp. (*In re* M. Paolella & Sons, Inc.), 161 B.R. 107, 118 (E.D. Pa. 1993), *aff'd*, 37 F.3d 1487 (3d Cir. 1994).

however, had found that the record contained no more than isolated examples of the exercise of that power.[92] Accordingly, the district court found the bankruptcy court's conclusion that PCA's claim could be subordinated based on a finding of inequitable conduct was in error. Each of the Bank, Cenex, and General was required to make a showing of gross or egregious misconduct to subordinate PCA's claim to its individual claim. The district court found that PCA's conduct with regard to the Bank and Cenex did not justify equitable subordination. The district court found, however, that PCA's conduct with respect to General, which consisted of misstatements to General indicating that the payments to the General would be forthcoming when PCA knew that was not the case, did rise to a level of gross or egregious misconduct and remanded to the bankruptcy court to determine the amount of General's claim to which PCA's claim should be subordinated.

Courts are unlikely to order equitable subordination when a noninsider lender (or a lender exercising virtually complete control so as to be treated as a fiduciary) simply has exercised its rights under a loan agreement. And courts are unwilling to require more of lenders than that for which the parties have contracted.[93]

In *Smith v. Associates Commercial Corp.* (*In re Clark Pipe & Supply Co.)*,[94] the United States Court of Appeals for the Fifth Circuit withdrew its earlier decision in the same case, and after a rehearing, held the lender not liable to its borrower. After the borrower had suffered a business slump, the secured lender began reducing the percentage advance rates so that the borrower would have just enough money to pay its direct operating expenses. As a consequence, the borrower barely had sufficient funds to keep its doors open and sell inventory. The sale of inventory created accounts receivable subject to the secured lender's security interests and cut off the sellers' liens held by certain vendors. The court's decision in favor of the lender primarily was based on its conclusion that a lender's compliance with the terms of its contract was not inequitable:

> The purpose of equitable subordination is to distinguish between the unilateral remedies that a creditor may properly enforce pursuant to its agreements with the debtor and other inequitable conduct such as fraud, misrepresentation, or the exercise of such total control over the debtor as

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[92] The bankruptcy court found that PCA was "'something in between' an insider in breach of fiduciary duty and a non-insider guilty of gross misconduct." *Id.*

[93] *See* Capitol Bank & Trust Co. v. 604 Columbus Ave. Realty Trust (*In re* 604 Columbus Ave. Realty Trust), 968 F.2d 1332, 1361 (1st Cir. 1992) ("For the most part, courts have been reluctant to find the requisite level of misconduct in arms-length dealings between borrowers and lenders."); *see also* Smith v. Assocs. Commercial Corp. (*In re* Clark Pipe & Supply Co.), 893 F.2d 693 (5th Cir. 1990), *withdrawing* 870 F.2d 1022 (5th Cir. 1989); Kham & Nate's Shoes No. 2, Inc. v. First Bank, 908 F.2d 1351 (7th Cir. 1990).

[94] 893 F.2d 693.

> to have essentially replaced its decision-making capacity with that of the lender.[95]

The court also acknowledged that in its initial decision it had been influenced improperly by the testimony of the lender's former loan officer that the lender's motive was "to get in the best position I can prior to the bankruptcy, i.e., I want to get the absolute amount of dollars as low as I can by hook or crook."[96] Upon reconsideration of its initial decision, the court determined that despite the "negative and inculpatory tone" of the testimony, the lender always acted consistently with the terms of the loan agreement. Consequently, the court ruled there had been no inequitable conduct on the part of the lender. Moreover, the lender was not a fiduciary of the borrower and it had exercised significantly less "control" over the borrower's activities than did the lender in *American Lumber*. The real distinction, observed the court, was that in the case before it, the borrower had retained the ability to act autonomously and disregard the advice of its lender.[97]

In *Kham & Nate's Shoes No. 2, Inc. v. First Bank*,[98] a bank had extended credit to a debtor prepetition. The debtor began to experience serious cash flow problems and asked for additional advances, which the bank agreed to provide only if the loan could be made fully secure. The debtor then filed a petition for relief under chapter 11 and the bankruptcy court granted the debtor's motion for an order authorizing financing pursuant to which the bank agreed to provide a $300,000 line of credit on a secured basis, subject to cancellation on five days' notice. The agreement included a provision that "[n]othing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time."[99] An initial borrowing by the debtor was completed and slightly more than one month after the date of the loan agreement, the bank gave notice that it would make no additional advances. Thereafter, the debtor proposed a plan of reorganization that treated the bank's claim as a general unsecured claim and the bank objected.

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[95] *Id.* at 701.

[96] *Id.* at 700.

[97] The court relied upon the decision of the Second Circuit in *In re W.T. Grant Co.*, which held that:

> The permissible parameters of a creditor's efforts to seek collection from a debtor are generally those with respect to voidable preferences and fraudulent conveyances proscribed by the Bankruptcy Act; apart from these there is generally no objection to a creditor's using his bargaining position, including his ability to refuse to make further loans needed by the debtor, to improve the status of his existing claims.

699 F.2d at 609-10; *see also In re* EDC, Inc., 930 F.2d 1275, 1281–82 (7th Cir. 1991) ("the doctrine of equitable subordination may not be used to impose obligations on parties above what they have agreed to, in the absence of evidence of overreaching not present here").

[98] 908 F.2d 1351 (7th Cir. 1990).

[99] *Id.* at 1353.

After an evidentiary hearing, the bankruptcy court concluded that the bank had behaved inequitably in terminating the line of credit and inducing the debtor's suppliers to draw on letters of credit, which had the effect of converting the bank's prepetition unsecured claim to a "superpriority" secured claim under the postpetition financing order.[100] The bankruptcy court then vacated its financing order and equitably subordinated the bank's claim. On appeal, however, the Seventh Circuit reversed, stating that it was unwilling:

> to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also to do "more"—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later. Contracts specify the duties of the parties to each other, and each may exercise the privileges it obtained. Banks sometimes bind themselves to make loans (commitment letters and letters of credit have this effect) and sometimes reserve the right to terminate further advances. Courts may not convert one form of contract into the other after the fact, without raising the cost of credit or jeopardizing its availability. Unless pacts are enforced according to their terms, the institution of contract, with all the advantages private negotiation and agreement brings, is jeopardized.
>
> "Inequitable conduct" in commercial life means breach plus some advantage-taking. . . . Firms that have negotiated contracts are entitled to enforce them to the letter, even to the great discomfort of their trading partners, without being mulcted for lack of "good faith."[101]

Subsequent decisions continue to demonstrate that a lender that merely exercises its contractual rights is unlikely to be found to have exerted the type of inequitable "control" that would justify equitable subordination. For example, in *United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc.*,[102] two contracts between Mobil and the debtor provided that the debtor was to sandblast and paint certain structures belonging to Mobil. However, the debtor failed to pay certain subcontractors for services rendered as required by the contracts. Accordingly, Mobil filed a proof of claim asserting a right to indemnification from the debtor for amounts expended to satisfy the liens of the subcontractors. The debtor filed a complaint seeking equitable subordination of Mobil's claim, contending that Mobil had exercised control over the financial affairs of the debtor to such an extent that other creditors suffered harm. The debtor argued that Mobil had refused to pay certain sums due under the two contracts, which represented nearly all the debtor's income flow. According to the debtor, this cutoff of its income stream forced it to pay certain secured parties to the detriment of unsecured creditors.

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[100] For a discussion of superpriority claims and debtor in possession financing, see Chapter [9].

[101] 908 F.2d at 1356–57, *cited in* Capitol Bank & Trust Co. v. Columbus Ave. Realty Trust (*In re* 604 Columbus Ave. Realty Trust), 968 F.2d 1332, 1362 (1st Cir. 1992).

[102] 39 F.3d 556 (5th Cir. 1994).

In analyzing the debtor's arguments, the United States Court of Appeals for the Fifth Circuit examined the two contracts between the debtor and Mobil and found three key provisions that led to the conclusion that Mobil's claim should not be equitably subordinated. First, a termination clause in each contract expressly permitted Mobil to terminate the contract at any time, with or without cause. Second, an indemnification clause provided that the debtor agreed to indemnify Mobil against the payment of, among other things, liens, indebtedness, or claims against its property. And third, a retainage clause authorized Mobil to withhold thirty percent of the money due to the debtor to ensure that the debtor would satisfy the claims of all subcontractors that might assert liens against Mobil's property. The court held that the very conduct alleged by the debtor to have been inequitable expressly was permitted by these three provisions. The court reasoned that although "Mobil's withholding of payment certainly created economic hardship for [the debtor], the act of withholding was made pursuant to Mobil's contractual right to do so . . . . Thus [the] economic leverage, asserted by Mobil pursuant to the terms of the contracts, did not give Mobil inequitable control over [the debtor]."[103]

INJURY OR UNFAIR ADVANTAGE

Depending on the particular circumstances of a case, all or a portion of a claim may be subordinated to some or even all other claims.[104] Equitable subordination is a remedial, not a penal, measure and should be used only sparingly.[105] A court will subordinate the claim of a creditor engaging in proscribed behavior only to the claims of those creditors that actually were injured by the inequitable conduct.[106] Thus, a claim held by one exhibiting behavior worthy of judicial disapprobation such that subordination is appropriate may be relegated to last priority in payment or merely may be placed in a position junior to the claims of those creditors harmed as a result of the proscribed

[103] *Id.* at 562; *see also* Holt v. Fed. Deposit Ins. Corp. (*In re* CTS Truss, Inc.), 868 F.2d 146 (5th Cir. 1989) (holding that a bank's alleged failure to fund notes executed by the borrower and the bank's refusal to provide additional financing pursuant to an oral agreement were insufficient to warrant equitable subordination because the bank was neither a fiduciary of the borrower nor in a position of control, and other creditors were not harmed as a result of their reliance).

[104] *See* 11 U.S.C. § 510(c).

[105] *See* Austin v. Chisick (*In re* First Alliance Mortgage Co.), 298 B.R. 652, 666-67 (citing U.S. Abatement Corp. v. Mobil Exploration & Producing, U.S. Inc., (*In re* U.S. Abatement Corp.), 39 F.3d 556, 561 (5th Cir. 1994)).

[106] *See* Benjamin v. Diamond (*In re* Mobile Steel Co.), 563 F.2d 692, 701 (5th Cir. 1977) ("[C]laims should be subordinated only to the extent necessary to offset the harm which the bankrupt and its creditors suffered on account of the inequitable conduct."); *see also* Allied Eastern States Maint. Corp. v. Miller (*In re* Lemco Gypsum), 911 F.2d 1553, 1556 (11th Cir. 1990); Trone v. Smith (*In re* Westgate-Cal. Corp.), 642 F.2d 1174, 1178 (9th Cir. 1981) ("The time-honored maxim that equity will not enforce a penalty adds another limitation to the subordination power. Bankruptcy courts must take care not to subordinate claims where doing so will operate only to penalize the claimant."); *In re* Kansas City Journal-Post Co., 144 F.2d 791, 800-801 (8th Cir. 1944) ("The power of subordination . . . can . . . ordinarily go no farther than to level off actual inequitable disparities on the bankruptcy terrain for which a creditor is responsible, to the point where they will not create unjust disadvantages in claim positions and liquidation results.").

conduct.[107] An objecting creditor bears the burden of demonstrating by a preponderance of the evidence that it suffered actual injury as a result of another creditor's proscribed conduct.[108]

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[107] Equitable subordination can be used only to reorder priorities, not to disallow claims. *See, e.g.*, 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (*In re* Nassau Assocs.), 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994). *But see In re* Outdoor Sports Headquarters, Inc., 168 B.R. 177, 181 (Bankr. S.D. Ohio 1994) ("The plain language of § 510(c)(1) pertains solely to the subordination of allowed claims based on equitable principles and is silent with regard to whether a claim may be disallowed on equitable principles."). Federal case law is divided over whether a claim may be disallowed upon equitable principles.

In Pepper v. Litton, the Supreme Court held that "disallowance or subordination in light of equitable considerations" may be made. 308 U.S. 295 (1939). Likewise, in Northtown Theatre Corp. v. Mickelson, the Eighth Circuit stated that the bankruptcy court "has the power to disallow or subordinate claims in the light of equitable considerations and can sift the circumstances surrounding any claim to see that injustice is not done in the administration of the bankruptcy estate." 226 F.2d 212 (8th Cir. 1955) (citations omitted). More recently, the Bankruptcy Court for the Southern District of Ohio found that the legislative history demonstrates that § 510(c) was enacted to codify case law such as Pepper v. Litton and "would authorize the court to disallow a claim based upon equitable principles." *See Outdoor Sports Headquarters*, 168 B.R. at 181-2 (citing H.R. Rep. No. 95-595, at 359 (1977) (stating § 510(c) "[i]s not intended to limit the court's power in any way. . . . Nor does this subsection preclude a bankruptcy court from completely disallowing a claim in appropriate circumstances.").

On the other hand, in *Mobile Steel*, the Fifth Circuit stated that "equitable considerations can justify only the subordination of claims, not their disallowance. 563 F.2d at 699. Various courts have reached the same conclusion. *See, e.g.,* Westek Ga., LLC v. Oglesbee (*In re* Westek Ga., LLC), No. 03-55298RFH, 04-5058, 2004 WL 2897947 (Bankr. M.D. Ga., Dec. 1, 2004); *In re* Century Inns, Inc., 59 B.R. 507 (Bankr. S.D. Miss. 1986); *In re* Delta Smelting & Ref. Alaska, Inc., 53 B.R. 877, 883 (Bankr. D. Alaska 1985). In Murgillo v. Cal. State Bd. of Equalization (*In re* Murgillo), the Ninth Circuit Bankruptcy Appellate Panel analyzed the legislative history of § 510(c) and reached a conclusion different from the one reached in *Outdoor Sports Headquarters*. 176 B.R. 524, 531-34 (B.A.P. 9th Cir. 1994). The panel acknowledged that equitable principles govern in bankruptcy proceedings, but found it was clear that principles of equity necessarily operated within the boundaries set by statutes: the bankruptcy court derives its equitable powers from § 105 of the Bankruptcy Code and a bankruptcy court may exercise its equitable power only as a means to fulfill some specific code provision; it may not use its equitable powers to achieve a result non contemplated by the Bankruptcy Code. Section 502 of the Bankruptcy Code provides that a claim will be allowed unless it falls within one of the enumerated exceptions. The panel concluded that the bankruptcy court should not use its equitable powers to carve out new exceptions. The panel went on to explain that "appropriate equitable considerations in claim allowance, therefore, would be those that harmonize with § 502(b) of the code, e.g., a determination as to whether a claim exists and is lawful; whether there is misconduct on the part of the creditor which renders the claim invalid or unenforceable against the debtor; and whether the debtor has a valid defense." *Id* at 532 n.14. In that way, an alleged inequity resulting when an innocent party in good faith asserts a legally valid claim would not suffice as an equitable basis to disallow a claim. The panel held that "the proper exercise of the bankruptcy court's equitable powers under § 502 is though investigation into the existence, validity and enforceability of claims leading to their allowance or disallowance; and the proper exercise of equitable powers regarding allowed claims is through the equitable subordination provisions of § 510(c)." *Id.* at 533.

In Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims (*In re* Papercraft Corp.), the Third Circuit found that the rational of Pepper v. Litton "would suggest that *under pre-Code law* a bankruptcy court was authorized to disallow a portion of the fiduciary's claim when that would produce an equitable result." 160 F.3d 982, 991 (3d Cir. 1998) (emphasis added). But the court found it unnecessary in that case to resolve the issue as to whether equitable disallowance remains an available remedy following the enactment of the Bankruptcy Code.

Although there is language in some cases to the effect that it is only inequitable conduct in "acquiring or asserting" the specific claim challenged that is relevant,[109] a number of courts have held that inequitable conduct directed against the debtor or its creditors may be sufficient to warrant subordination of a claim irrespective of whether such conduct was related to the acquisition or assertion of that claim.[110] In those courts, "the creditor must fear not only a challenge to its actions involving the disputed claim, but also an assertion that during the course of the commercial relationship, the 'creditor [was] guilty of some act involving moral turpitude or some breach of duty or some misrepresentation' causing damage to the bankrupt or its creditors."[111]

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[108] *See Mobile Steel*, 563 F.2d at 701. *But see* Official Comm of Unsecured Creditors v. Austin Fin. Serv., Inc. (*In re* KDI Holdings, Inc.), 277 B.R. 493, 509 (Bankr. S.D.N.Y. 1999) ("To satisfy the second prong [of the *Mobile Steel* test], the proponent of equitable subordination need only allege 'that general creditors are less likely to collect their debts' as a result of the allegedly inequitable conduct. . . . If misconduct results in harm to the entire creditor body the objecting party need not identify the injured creditors or quantify their injury, but need only show that the creditors were harmed in some general concrete manner.") (citing 80 Nassau Assocs. v. Crossland Fed. Sav. Bank (*In re* 80 Nassau Assocs.), 169 B.R. 832, 840 (Bankr. S.D.N.Y. 1994)). "Once an objectant in an insider case supports allegations of impropriety with a substantial factual showing, the burden shifts to the insider creditor to proved the good faith and inherent fairness of its actions." Bank of New Richmond v. Prod. Credit Ass'n (*In re* Osborne), 42 B.R. 988 996 (W.D. Wis. 1984) (citing *Mobile Steel*, 563 F.2d at 701-02). "However, the burden remains on the objectant in cases involving non-insider creditors." *Id.* (citing Anaconda-Ericsson v. Hessen (*In re* Teletronics Servs., Inc.), 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983)).

[109] *See, e.g.,* Prudence Realization Corp. v. Geist, 316 U.S. 89, 95 (1942) ("[T]he equity powers of the bankruptcy court may be extended to subordinate the claims of one claimant to those of others of the same class where his conduct in acquiring or asserting his claim is contrary to established equitable principles."); Stebbins v. Crocker Citizens Nat'l Bank (*In re* Ahlswede), 516 F.2d 784, 788 (9th Cir. 1975) ("[T]here must be conduct either in acquiring or asserting the claim which is itself inequitable in order to subordinate a claim.").

[110] *See Mobile Steel*, 563 F.2d at 701 (citing *In re* Kansas City Journal-Post Co., 144 F.2d 791 (8th Cir. 1944)); *In re* Lifschultz Fast Freight, 132 F.3d 339, 354 (7th Cir. 1997); N.J. Steel Corp. v. Bank of N.Y., No. 95 Civ. 3071 (KMW), 1997 WL 716811 (S.D.N.Y. Nov. 17, 1997); Mishkin v. Siclari (*In re* Adler, Coleman Clearing Corp.), 277 B.R. 520, 566 (Bankr. S.D.N.Y. 2002) (citing *80 Nassau Assocs*., 169 B.R. at 838); *In re* After Six, Inc., 177 B.R. 219, 231 (Bankr. E.D. Pa. 1995). Faced with language from the Supreme Court that was adopted by the Ninth Circuit in *Ahlswede*, 516 F.2d at 788, *see supra* note 109, the Fifth Circuit stated that the "narrow conception of what misconduct is pertinent was adopted inadvertently. Improper acts unconnected with the acquisition or assertion of a particular claim have frequently formed at least a part of the basis for the subordination of that claim. Moreover, [the Fifth Circuit] ha[s] found no case in which a federal court refused to subordinate a claim solely because, although inequitable conduct of sufficient magnitude to warrant subordination existed, the conduct was unrelated to the acquisition or assertion of the particular claim whose status was at issue." *Mobile Steel*, 563 F.2d at 700-01 (citing Taylor v. Standard Gas & Elec. Co., 305 U.S. 584, (1939) (the "Deep Rock" case).

[111] Dickens, *supra* note 74, at 807-08 (citing Miller v. Borton (*In re* Bowman Hardware & Elec. Co.), 67 F.2d 792, 794 (7th Cir. 1933)).

"CONTROLLING PERSON" LIABILITY

A lender may incur liability under section 20(a) of the Exchange Act as a "controlling person" of a borrower that violates securities laws.[112] It has been held that the allegation that a lender controls the daily affairs of its borrower, though difficult to prove, is sufficient to state a cause of action for liability as a controlling person under section 20(a).[113] However, it also has been held that unless a bank is acting as a broker or in a capacity closely analogous to a broker, it does not owe a fiduciary duty under federal securities laws to a purchaser of the borrower's securities.[114]

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[112] Section 20(a) of the Exchange Act provides that:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U.S.C. § 78(t)(a); *see also* Loftus C. Carson, *The Liability of Controlling Persons Under the Federal Securities Act*, 72 NOTRE DAME L. REV. 263 (1997); James L. Burns, *Pruning the Judicial Oak: Developing a Coherent Application of Common Law Agency and Controlling Person Liability in Securities Cases*, 93 COLUM. L. REV. 1185 (1993).

[113] *In re* Falstaff Brewing Corp. Antitrust Litig., 441 F. Supp. 62 (E.D. Mo. 1977); *see also* SEC v. Chester Holdings, Ltd., 41 F. Supp. 2d 505, 526-27 (D.N.J. 1999) (noting that liability attaches when a party has "the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." (citing Rochez Bros., Inc. v. Rhoades, 527 F.2d 880, 890 (3d Cir. 1975) (quoting 17 C.F.R. § 240.12b-2(f)). To establish a prima facie case under section 20(a) of the Exchange Act, a plaintiff must show: "(1) a primary violation by a controlled person; (2) control of the primary violator by the defendant; and (3) 'that the controlling person was in some meaningful sense a culpable participant' in the primary violation.'" Cromer Fin. Ltd. v. Berger, 137 F. Supp. 2d 452 (S.D.N.Y. 2001) (quoting Boguslavsky v. Kaplan, 159 F.3d 715, 720 (2d Cir. 1998) (quoting SEC v. First Jersey, 101 F.3d 1450, 1472 (2d Cir. 1996))). In *Cromer*, where the it was alleged that an accounting firm's associate owned and controlled two offshore entities through which it provided administrative services to a fund and that its own personnel participated in the fraud by various means, the court found that control person liability under section 20(a) of Exchange Act was sufficiently plead in a suit against the firm for losses sustained by investors in the insufficiently capitalized offshore fund. *Id*. at 484; *see also In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 517 (S.D.N.Y. 2005) (allegations of control as against lenders, while not sufficiently detailed, were sufficient to state claim); *In re* WorldCom, Inc. Sec. Litig., 294 F. Supp. 2d 392, 415-16 (S.D.N.Y. 2003) (same).

[114] Drake v. Letterman Transaction Servs. (*In re* Letterman Bros. Energy Sec. Litig.), 799 F.2d 967 (5th Cir.), *cert. denied*, 480 U.S. 918 (1987); see also Webster v. Centex Home Equity Corp. (*In re* Webster), 300 B.R. 787, 791 (Bankr. W.D. Okla. 2003) (noting that lender would be liable if a broker acted as its agent).

Generally, courts have refused to hold lenders liable under federal securities laws for aiding and abetting the commission of securities law violations by their borrowers.[115] For example, in *Woodward v. Metro Bank,*[116] the court held that a lender was not liable under federal securities laws to an accommodation maker of the borrower's note for aiding and abetting the borrower's securities laws violations. The court rejected the accommodation maker's argument that, at the time of cosigning the note, the lender had the duty to disclose its knowledge of the borrower's precarious financial condition.[117]

The availability of the aiding and abetting cause of action by private borrowers has been curtailed significantly by the United States Supreme Court's decision in *Central Bank, N.A. v. First Interstate Bank, N.A.*,[118] which held that no private party may maintain an aiding and abetting cause of action under rule 10b-5 of the Exchange Act,[119] the major antifraud federal securities law regulation.[120] Accordingly, as set forth by the United States Court of Appeals for the Second Circuit,

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[115] As set forth by the United States Court of Appeals for the Sixth Circuit, "[w]ithout meaning to set forth an inflexible definition of aiding and abetting, we find that a person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation." SEC v. Coffey, 493 F.2d 1304, 1316 (6th Cir.), *cert. denied*, 420 U.S. 908 (1974). For other formulations of the aiding and abetting test, see Bane v. Sigmundr Exploration Corp., 848 F.2d 579 (5th Cir. 1988); Armstrong v. McAlpin, 699 F.2d 79 (2d Cir. 1983); Nat'l Union Fire Ins. Co v. Cooper, 729 F. Supp. 1423, 1428 (S.D.N.Y. 1989).

[116] 522 F.2d 84 (5th Cir. 1975).

[117] In rare instances, however, courts have held lenders to be liable under this theory. *See, e.g.*, First Va. Bankshares v. Benson, 559 F.2d 1307 (5th Cir.) (holding lender liable for failure to disclose in its extensive communications with the prospective purchaser the improprieties in the borrower's financial condition), *cert. denied*, 435 U.S. 952 (1978).

[118] 511 U.S. 164 (1994), *superseded in part by statute*, 15 U.S.C. § 78t(e) (permitting public prosecution of aiding and abetting violations).

[119] 17 C.F.R. § 240.10b-5 (1997).

[120] *See, e.g.*, Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] defendant must actually make a false a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b).") (internal quotation marks omitted); Paracor Fin., Inc. v. Gen. Elec. Capital Corp., 96 F.3d 1151, 1161 n.11 (9th Cir. 1996) (noting the inapplicability of the aiding-and-abetting cause of action to a private borrower under Rule 10b-5 following *Central Bank*). Nonetheless, the United States Supreme Court in *Central Bank* did not conclude that secondary actors such as lawyers, accountants, banks and underwriters were always shielded from liability under Rule 10b-5 of the Exchange Act. *Central Bank*, 511 U.S. at 191. To the contrary, *Central Bank* holds that any person or entity may be liable as a primary violator under Rule 10b-5 of the Exchange Act. *Id.*; *see also In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472 (S.D.N.Y. 2005); Quaak v. Dexia, S.A., 357 F. Supp. 2d 330 (D. Mass. 2005); *In re* Enron Corp. Secs., 235 F. Supp. 2d 549, 582-83 (S.D. Tex. 2002) (discussing *Central Bank*).

> [A] defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b) . . . . [A] secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination . . . . The misrepresentation must be attributed to that specific actor at the time of public dissemination . . . .[121]

While the Exchange Act was later amended to authorize the SEC to bring injunctive actions against those who knowingly aid and abet securities fraud,[122] the statute was not amended to authorize private aiding and abetting liability actions.[123]

TRUST INDENTURE ACT LIABILITY

A lender that also serves as an indenture trustee for an issue of debt securities of its borrower has a fiduciary duty to holders of the debt securities not to profit at their expense. The Trust Indenture Act of 1939 (TIA)[124] requires qualification of an indenture governing public debt securities, and in that regard, proscribes provisions exculpating an indenture trustee from liability for negligence or willful misconduct.[125]

This principle was demonstrated in one case where the court recognized a private right of action under the TIA for lender liability due to wrongful misconduct and breach

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[121] *Wright*, 152 F.3d at 175 (quoting Shapiro v. Canotr, 123 F.3d 717, 720 (2d Cir. 1997)); *see also Parmalat Sec. Litig*., 376 F. Supp. 2d 472 (discussing aiding and abetting liability both before and after *Central Bank*)

[122] *See* Private Securities Litigation Reform Act of 1995, codified at 15 U.S.C. § 78u-4(b)(3)(A) (PSLA). The PSLA specifically authorized the SEC to bring enforcement actions against those who "knowingly provide[ ] substantial assistance to another person" in violation of the federal securities laws. 15 U.S.C. § 78t(f); *see also* SEC v. Fehn, 97 F.3d 1276, 1282-84 (9th Cir. 1996) (noting that the amendment to 15 U.S.C. § 78t reversed any impact that *Central Bank* might have had on the SEC's power to enjoin aiding and abetting), *cert. denied*, 522 U.S. 813 (1997); Newby v. Enron Corp. (*In re* Enron Corp. Sec.), 310 F. Supp. 2d 819, 827 (S.D. Tex. 2004).

[123] *See* S. REP. NO. 95-98 (1995). One commentator, however, suggests that courts post-*Central Bank* have applied a "substantial participation" approach for determining primary liability in the creation of false statements, which he suggest may actually be aiding and abetting in disguise. *See* 2 GERALD L. BLANCHARD, LENDER LIABILITY: LAW, PRACTICE & PREVENTION § 20:44.10 (2003) (citing Howard v. Everex Sys., Inc. 228 F.3d 1057, 1061 n.5 (9th Cir. 2000)).

[124] 15 U.S.C. §§ 77aaa–77bbbb.

[125] *See* Trust Indenture Act of 1939 § 315(d), 15 U.S.C. § 77ooo(d). Nothing in the TIA creates any fiduciary duty beyond those duties set forth in a specific indenture, but it does not preclude the imposition of state fiduciary duties on indenture trustees. Broad v Rockwell Int'l Corp., 614 F.2d 418 (5th Cir. 1980), *different results reached on reh'g*, 642 F.2d 929 (5th Cir.), *cert. denied*, 454 U.S. 965 (1981).

of indenture provisions.[126] Although the court acknowledged that the lender's maintenance of a dual relationship as the indenture trustee and as the issuer's creditor did not alone violate the statute, the court refused to dismiss a claim that the indenture trustee/lender negotiated its secured loan having priority over the bondholders' claims in flagrant disregard of the bondholders' interests.[127]

ENVIRONMENTAL CLEAN-UP LIABILITY

The Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996[128] substantially protects lenders from liability for the obligations of borrowers for cleanup costs incurred by the government in connection with hazardous materials located on real property owned by the borrower and pledged to the lender as collateral. The Act includes amendments to the Comprehensive Environmental Response Compensation and Liability Act of 1980[129] (CERCLA) and the underground storage tank provisions of the Resource Conservation and Recovery Act of 1976.[130] In addition, several cases suggest a trend away from imposing liability on lenders pursuant to CERCLA and its state law counterparts.[131]

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[126] Morris v. Cantor, 390 F. Supp. 817 (S.D.N.Y. 1975); *see also* Zeffiro v. First Penn. Banking & Trust Co., 623 F.2d 290 (3d Cir. 1980) (holding that the TIA provided injured bondholders with federal cause of action for breach of terms mandated by the TIA).

[127] The lender's resignation as indenture trustee after negotiations concluded, but prior to the loan's consummation, did not protect it from bondholder claims that it breached its duty as a trustee. *See* Morris, 390 F. Supp. at 824; *see also* Cosoff v. Rodman (*In re* W.T. Grant Co.), 699 F.2d 599, 611–12 (2d Cir.) (indenture trustee that also is lender does not act improperly when it takes security superior to claims of bondholders if the trustee/lender is advancing new money rather than improving its position with respect to prior obligations of the borrower), *cert. denied*, 464 U.S. 822 (1983).

[128] Pub. L. No. 104-208, 110 Stat. 3009-462 (amending 42 U.S.C. §§ 6991b, 9601, 9607).

[129] 42 U.S.C. §§ 9601–9615, 9633, 9641, 9651, 9657.

[130] *Id*. §§ 6901-6907, 6911-6916, 6921-6931, 6941-6949, 6951-6954, 6961-6964, 6971-6979, 6981-6986. CERCLA liability is extremely broad, imposing strict, joint and several liability for damages on all past and present "owners or operators" of "facilities" that release or threaten to release or "dispose" hazardous substances into the environment. *See id.* § 9601(9), (20), (22), (14). There is, however, the so-called "security interest exemption" from CERCLA's strict liability scheme. Specifically, § 101 of CERCLA provides that "[t]he term 'owner or operator' . . . does not include a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect [its] security interest in the vessel or facility." *Id.* § 9601(20)(A). In Waterville Indus. v. Finance Auth., 984 F.2d 549 (1st Cir. 1993), the court noted that "[t]he purpose of this exception is to shield from liability those 'owners' who are in essence lenders holding title to the property as security for the debt," and held that a lender that merely holds title while attempting to divest itself of the property within a reasonable time falls within the security interest exemption and therefore is not liable for clean-up costs. *Id*. at 552; *see also* Monarch Tile, Inc. v. City of Florence, 212 F.3d 1219 (11th Cir. 2000) (holding that lender was a secured creditor under CERCLA); Hill v. East Asiatic Co. (*In re* Bergsoe Metal Corp.), 910 F.2d 668 (9th Cir. 1990) (holding that there must be actual management of the facility by the lender to impose "owner liability").

[131] *See* Kelley ex rel. Mich. Natural Res. Comm'n v. Tiscornia, No. 94-1403, 1996 WL 732323 (6th Cir. Dec. 19, 1996) (evidence did not support finding that lender exercised decisionmaking control over

TAX LIABILITY

Lenders should note several points regarding their potential tax liability in connection with their loans to borrowers. For example, a lender that funds the borrower's payroll directly is liable to the federal government for any unpaid Social Security and income withholding taxes.[132] And where a lender supplies funds to a borrower for the purpose of paying employee wages and has "actual notice or knowledge" of either the borrower's inability to pay withholding taxes or the borrower's intent not to pay such taxes, the lender is liable therefor.[133] As the United States Supreme Court noted, "[t]he lender is deemed to have such actual notice or knowledge from the time the lender, in the exercise of due diligence, would have been aware that the employer would not or could not make timely payment."[134]

When the borrower fails to pay certain federal tax obligations, the IRC imposes liability on the lender irrespective of whether the lender exercised control over the borrower. However, the penalty that can be assessed against the lender is greater if

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borrower's environmental compliance or assumed or manifested responsibility for the overall management of day-to-day decision making with respect to environmental compliance); *see also* United States v. McLamb, 5 F.3d 69 (4th Cir. 1993) (finding mortgagee that did not disclose contamination to purchaser not liable under CERCLA); U.S. v. Odabashian, No. 95-2361 G/BRE, 1999 WL 33944046 (W.D. Tenn. Mar. 22, 1999) (lender that held property for three years not liable for clean-up costs where lender held property merely to sell it to protect its security interest and was unable to find a willing buyer); Northeast Doran, Inc. v. Key Bank, No. Civ. 92-0247-B, 1993 WL 313629 (D. Me. June 4, 1993) (finding mortgagee can avoid CERCLA liability even when it conceals contamination from buyer), *aff'd*, 15 F.3d 1 (1st Cir. 1994); Ashland Oil, Inc. v. Sonford Prods. Corp., 810 F. Supp. 1057 (D. Minn. 1993) (lender that foreclosed and held collateral for one month not liable under CERCLA); MidSouth Rail Corp. v. Citizens Bank & Trust Co., 697 So. 2d 451 (Miss. Sup. Ct. 1997) (lender not liable under Mississippi statute for environmental clean-up costs); Decoudreaux v. Mutual Fed. Sav. & Loan Ass'n, 455 S.E.2d 88 (Ga. Ct. App. 1995) (lender not liable for CERLCA clean-up costs merely because of inspection of property); *cf.* U.S. v. Fleet Factors Corp., 821 F. Supp. 707 (S.D. Ga. 1993) (lender liable for CERCLA clean-up costs post-foreclosure because lender haphazardly moved drums containing hazardous asbestos materials, thereby aggravating the site's contamination, and the hazard, performed without supervision, was apparent and serious); City of Phoenix, Az. v. Garbage Servs. Co., 816 F. Supp. 564 (D. Ariz. 1993) (bank/trustee that owned contaminated property found liable under CERCLA). For a detailed discussion of environmental considerations in restructurings, see Chapter [23].

[132] I.R.C. § 3505; *see, e.g.*, Luria v. Std. Fed. S&L Ass'n, No. 04-1356, 2004 WL 2667359, at *8 (4th Cir. Oct. 28, 2004).

[133] I.R.C.. § 6323(i)(1). The fact that a lender makes loans to a corporate employer that is failing to pay over withheld federal income employment taxes to the United States will not, without more, subject the lender to liability. *Id*. § 6672.

[134] Jersey Shore State Bank v. United States, 479 U.S. 442, 448 (1987) (citing *id.*). According to the court in United States v. Swiftships, Inc., No. Civ. A. 94-2597A, 1995 WL 696614, at *9 (E.D. La. Nov. 22, 1995), the duty to perform due diligence does not impose upon the lender a duty to inquire outside the lender's organization.

control by the lender is found. If the lender is found to control corporate disbursements, a 100% penalty is imposed.[135]

"HOT GOODS"

A secured lender that forecloses on inventory and goods of its borrower may run afoul of the "hot goods" provisions of the FLSA[136] if the borrower has not been meeting its payroll obligations. Under the FLSA, it is unlawful for any person to transport, ship, or deliver goods in interstate commerce that are produced by workers who are not being compensated legally under the minimum wage and overtime wage provisions of the FLSA.[137] In *Citicorp Industrial Credit v. Brock*,[138] the United States Supreme Court held that the statute applies to a secured lender that forecloses on goods produced in violation of the FLSA compensation statutes. In *Brock,* the lender had foreclosed in response to the borrower's insolvency and default. The merchandise included goods produced after the borrower had defaulted on its payroll. The Supreme Court upheld the lower courts' injunction against the lender's shipping "hot goods" in interstate commerce.[139] Notably, control of the borrower is not required for a secured lender to face a "hot goods" injunction under the FLSA.

RICO

RICO[140] was adopted in 1970 as title IX of the Organized Crime Control Act of 1970 to prevent the infiltration of organized crime into legitimate commercial enterprises. In

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[135] I.R.C. § 6672. This section was "designed to cut through the shield of organizational form." *See* Pac. Nat'l Ins. Co. v. United States, 422 F.2d 26, 30–31 (9th Cir.), *cert. denied*, 398 U.S. 937 (1970); *see also* Commonwealth Nat'l Bank v. United States, 665 F.2d 743, 757 (5th Cir. 1982) (lender liable under I.R.C. § 6672 where payroll checks subject to a lockbox arrangement were honored but withholding-tax checks were not).

[136] 29 U.S.C. §§ 201-219.

[137] *Id*. § 215(a)(1).

[138] 483 U.S. 27 (1987).

[139] The Court in *Brock* reasoned that section 215(a)(1) of the FLSA prohibits "any person" from introducing goods produced in violation of FLSA into interstate commerce; section 203(a) of the FLSA defines "person" as "an individual, partnership, association, corporation, business trust, legal representative, or any organized group." 28 U.S.C. § 203(a)(1). The Court concluded "as a corporate entity, petitioner clearly falls within the plan language of this statute." 483 U.S. at 33. For other instances involving a secured lender and the "hot goods" provisions of the FLSA, see Secretary of Labor v. 3re.com, 317 F.3d 534 (6th Cir. 2003) (secured creditor successfully challenged the classification of accounts receivable as "hot goods" under the FLSA); Reich v. Midwest Body Corp., 843 F. Supp. 1249 (N.D. Ill. 1997) (secured lender conceded it was responsible for FLSA obligations and was prevented from the sale of the "hot goods" in question); *In re* Sw. Equip. Rental, 102 B.R. 132 (E.D. Tenn. 1989) (court granted lender's motion to dismiss "hot goods" action); *see also* Chao v. 3RE.com, Inc., No. 01-2350-MlV, 2003 WL 21946597 (W.D. Tenn. July 28, 2003).

[140] *See* 18 U.S.C. §§ 1961-1968.

addition to criminal penalties, RICO provides that private entities injured in their business or property by activity of an "enterprise" through a "pattern of racketeering activity" may sue and recover treble damages.[141] Private civil remedies coupled with liberal construction[142] and a broad definition of racketeering resulted in an explosion of civil litigation under RICO in the mid-1980s.[143] The increase in private lawsuits has evoked substantial debate, and several Supreme Court decisions have addressed the scope and availability of civil remedies under RICO.[144]

Common situations in which commercial borrowers assert RICO claims against lenders include alleged misrepresentation of the "prime rate" of interest,[145] alleged fraud in a

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[141] *Id.* § 1964(c). "Racketeering activity," means "any act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion, dealing in obscene matter, or dealing in a controlled substance or listed chemical. *Id*. § 1961(1)(A). An "enterprise" can be '"any individual, partnership, corporation, association or other legal entity," as well as any "union or group of individuals associated in fact although not a legal entity." *Id*. § 1961(4); *see also* First Capital Asset Mgmt., Inc. v. Saintwood, Inc., 385 F.3d 159 (2d Cir. 2004) (a bankruptcy estate under certain circumstances may constitute an "enterprise"). RICO defines a "pattern of racketeering activity" as requiring at least two acts of racketeering activity, "one of which occurred after [the enactment of RICO] and the last of which occurred within 10 years . . . after the commission of a prior act of racketeering activity." *Id.* § 1961(5).

[142] *See* Pub. L. No. 91-452, § 904(a) (1970) ("the provisions of this title shall be liberally construed to effectuate its remedial purposes").

[143] One commentator explains the reason for this growth as follows:

> The primary reason for this growth in the use of the statute in civil litigation, particularly against financial institutions, is that the actions which comprise racketeering activity may include mail fraud, wire fraud, and securities fraud. Since mail fraud and wire fraud includes any alleged fraudulent activity taking place over the telephone or through the mails, most plaintiffs are able to elevate what formerly would have been a state common law fraud claim into a federal RICO claim for treble damages and attorney fees.

2 BLANCHARD, *supra* note 123, § 18.01 (footnotes omitted); *see also* Elizabeth A. Skorcz, Comment: *RICO Forfeiture: Secured Lenders Beware*, 37 UCLA L. REV. 1199 (1990); William H. Rehnquist, *Remarks of the Chief Justice*, 21 ST. MARY'S L.J. 5, 9 (1989).

[144] *See, e.g.*, Scheidler v. Nat'l Org. for Women, Inc. (Scheidler II), 537 U.S. 393, 397 (2003) (limiting the predicate racketeering act of extortion); Reves v. Ernst & Young, 507 U.S. 170, 183-85 (1993) (limiting private liability under § 1962(c) despite the liberal construction clause); H.J. Inc. v. Nw. Bell Tel. Co., 492 U.S. 229, 255-56 (1989) (Scalia, J., concurring) (concluding that broad civil and criminal application of RICO made it susceptible to future challenge); Sedima, S.P.R.L. v. Imrex Co., 473 U.S. 479, 529 (1985) (Powell, J., dissenting) (disagreeing with the Court's conclusion to read the civil RICO provisions expansively); *see also* Daniel Herbst, *Comment: Injunctive Relief and Civil RICO: After Scheidler v. National Organization for Women, Inc., RICO's Shape and Remedies Require Reevaluation*, 53 CATH. U. L. REV. 1125 (2004).

[145] *See*, *e.g.*, Lum v. Bank of Am., 361 F.3d 217 (3rd Cir. 2003) (no liability found); Walters v. First Tenn. Bank, 855 F.2d 267 (6th Cir.), *cert. denied*, 489 U.S. 1067 (1989); Ctr. Cadillac, Inc. v. Bank Leumi Trust Co., 859 F. Supp. 97 (S.D.N.Y. 1994), *aff'd*, 99 F.3d 40 (2d Cir. 1995); Rubin Bros. Footwear, Inc. v. Chemical Bank (*In re* Rubin Bros. Footwear Inc.), 73 B.R. 346 (S.D.N.Y. 1987). *But see* Goldfine v Sichenzia, 118 F. Supp. 2d 392 (S.D.N.Y. 2002) (lenders' claim against borrowers who allegedly schemed to make lenders lose priority by failing timely to file various instruments securing loans, is dismissed as premature where lenders have not suffered any recognizable RICO damages).

refinancing or a workout,[146] and cases arising out of a workout, situation or bankruptcy case.[147]

TORTS BY THE LENDER

Many borrowers and their customers have succeeded in their actions against lenders based on various tort theories. The facts upon which these actions have been founded are diverse, but the cases illustrate the various types of conduct out of which lender liability may arise in the absence of a finding of control or fiduciary relationship.[148]

FRAUD AND MISREPRESENTATION

In *State National Bank v. Farah Manufacturing Co.*[149] (discussed above), the lenders' attorney wrote a letter to the borrower's board of directors indicating that the borrower's

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[146] *See, e.g.*, VanDenBroeck v. CommonPoint Mortgage Co., 210 F.3d 696, 700 (6th Cir. 2000) (rejecting a RICO a claim against defendant bank and a series of sub-lenders because there were no allegations of an "enterprise" and a mechanism by which the group "conducted its affairs or made decisions"); Bancoklahoma Mortgage Corp. v. Capital Title Co., 194 F.3d 1089 (10th Cir. 2000) (no liability found where plaintiff failed to establish elements of RICO claim in connection with defendant's purchase of lender's refinance loans); Emery v. Am. Gen. Fin., Inc., 71 F.3d 1343 (7th Cir. 1995) (liability found where lender failed to advise borrower that taking a new loan would be cheaper than refinancing the existing loan); Morosani v. First Nat'l Bank, 703 F.2d 1220 (11th Cir. 1983) (holding that the act of a bank improperly charging excessive interest clearly fell within the requirements of a violation of RICO); Beard v. Worldwide Mortgage Corp., 354 F. Supp. 2d 789 (W.D. Tenn. 2005) (title company/lender motion to dismiss RICO claim denied where it was alleged that documents relating to home refinancing were misleading and incorrect); Matthews v. New Century Mortgage Corp., 185 F. Supp. 2d 874 (S.D. Ohio 2002 (borrower's RICO claim against lender not barred by statute of limitations because statute was tolled due to lender's fraud); Eva v. Midwest Nat'l Mortgage Banc, Inc., 143 F. Supp. 2d 862 (N.D. Ohio 2001) (plaintiffs sufficiently pled discriminatory lending activities directed at females borrowers for residential loans); Stewart v Assocs. Consumer Disc. Co., 1 F. Supp. 2d 469 (E.D. Pa. 1998) (consumer borrower's claim may proceed where she entered into a refinancing she thought would result in payoff of her first mortgage and other debts and a 9.8% loan payable in 10 years, when she was given a 15.08% loan secured by a second mortgage and the enterprise had been soliciting via false advertising); S. Fed. Sav. & Loan Ass'n v. 21-26 E. 105th St. Assocs., 145 B.R. 375 (S.D.N.Y. 1991) (no liability found), *aff'd*, 978 F.2d 706 (2d Cir. 1992); Blue Line Coal Co. v. Equibank, 769 F. Supp. 891 (E.D. Pa. 1991) (no liability found); *see also* Kimm Tynan, Note, *Pennsylvania Welcomes Predatory Lenders: Pennsylvania's Act 55 Preempts Philadelphia's Tough Ordinance But Provides Little Protection for Vulnerable Borrowers*, 34 RUTGERS L. J. 837 (2003).

[147] *See, e.g.*, Secon Serv. Sys., Inc. v. St. Joseph Bank & Trust Co., 855 F.2d 406 (7th Cir. 1988); Lawaetz v. Bank of Nova Scotia, 653 F. Supp. 1278 (D.V.I. 1987).

[148] *See*, *e.g.*, Roberts v. Wells Fargo AG Credit Corp., 990 F.2d 1169 (10th Cir. 1993) (cause of action based on lender's failure to renew line of credit); Schelling v. Budd (*In re* Agribiotech, Inc.), 291 F. Supp. 2d 1186 (D. Nev. 2003) (misrepresentation can arise out of attendance at a meeting or approval of a form of letter); Bank of India v. Trendi Sportswear, Inc., No. 89 Civ. 5996 JSM, 2002 WL 84631 (S.D.N.Y. Jan. 18, 2002) (lender impleaded in action alleging various torts, including loss profit damages and loss of business reputation and good will), *aff'd*, 64 Fed Appx. 827 (2d Cir.), *cert. denied*, 540 U.S. 1074 (2003).

[149] 678 S.W.2d 661 (Tex. Ct. App. 1984), *writ granted, judgment set aside*, *cause dismissed* (Mar. 6, 1985).

loans would be in default under the management change clause of its loan agreement if Mr. Farah was elected chief executive officer of the borrower. The bank also threatened to padlock the borrower and force it into bankruptcy if Mr. Farah was elected. The evidence showed, however, that at the time of these threats the lenders either had determined not to declare the default nor reached a decision on whether to declare it.[150] Accordingly, the court held that the lenders' statements were intended to and did create a false impression of their position on whether to consider the loan in default, and as a result, such misrepresentations constituted actionable fraud.[151] The court also held that the evidence of the misrepresentations established that the lenders willfully or intentionally interfered with the business relations of the borrower without just cause or excuse, which resulted in the lenders' liability for damages for tortious interference with business relations.[152]

Lenders should be aware that liability for fraudulent misrepresentation can result in the imposition of substantial punitive damages. For example, the Kentucky Supreme Court affirmed the award of punitive damages against a bank that induced two individuals and their companies to restructure a loan on terms that the court found the bank had no intention of performing.[153] Notably, the court found that punitive damages amounting to $5,775,000 were not excessive although the compensatory damages awarded were only $1,065,000.[154]

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[150] *Id.* at 667.

[151] *Id.* at 682; *see also* Gen. Motors Acceptance Corp. v. Cent. Nat'l Bank, 773 F.2d 771 (7th Cir. 1985) (affirming judgment for plaintiff finance company against bank for fraud based on misrepresentations made in connection with a car dealership's checking account); Jairett v. First Montauk Sec. Corp., 203 F.R.D. 181 (E.D. Pa. 2001) (statement of intent that is false can constitute a fraudulent misrepresentation). To prosecute a claim for fraud and misrepresentation successfully, a proponent must establish that certain facts were misrepresented or omitted, and that a party reasonably relied upon such misrepresentations or omissions to its detriment. *See, e.g.*, Nat'l Westminster Bank, U.S.A. v. Ross, 130 B.R. 656, 664 (S.D.N.Y. 1991), *aff'd sub nom*. Yaeger v. Nat'l Westminster Bank, 962 F.2d 1 (2d Cir. 1992).

[152] *Nat'l Westminster*, 130 B.R. at 683. Further, the lenders' warnings that they would declare a default under the management change clause and force the borrower into bankruptcy should Mr. Farah be elected chief executive officer, and the lenders' prevention of the election of pro-Farah directors, were found by the court to establish an actionable claim for economic duress. *Id.* at 686–87. An action for duress occurs in circumstances where the lender demands more than the borrower is legally obligated to give at a time when the borrower may have little choice other than to give in to the lender's demands. 1-5 LENDER LIABILITY LAW AND LITIGATION (MB) § 5.06 (2004); *see also* Romero v. Bank of the Sw., No. 22,635, 2003 WL 22508849 (N.M. Ct. App. Aug. 20, 2003); Sanchez-Corea v. Bank of Am., 701 P.2d 826 (Cal. 1985) (liability found where misrepresentations were made by lender to gain additional collateral for outstanding loans).

[153] Hanson v. Am. Nat'l Bank & Trust Co., 844 S.W.2d 408 (Ky. 1992), *vacated and remanded*, 509 U.S. 918, *aff'd on remand*, 865 S.W. 2d 302 (1993); *see also* Sallee v. Fort Knox Nat'l Bank, N.A. (*In re* Sallee), 286 F.3d 878 (6th Cir. 2002); Hoffman v. Stamper, 867 A.2d 276 (Md. 2005). *But see* Austin v. Chisick (*In re* First Alliance Mortgage Co.), No. SA CV 01-971, 2003 WL 21530096 (C.D. Cal. June 16, 2003) (punitive damages not appropriate in case against secondary lenders).

[154] *Hanson*, 844 S.W.2d at 416; *see also* Club 93, Inc. v. First Sec. Bank, Nos. 97-35919 & 97-35920, 1999 WL 310640 (9th Cir. May 7, 1999) (punitive damages were justified since there were repeated

Based on a lender's misrepresentations, courts have held lenders liable to third parties as well as to borrowers,[155] and some courts have imposed liability on lenders based not only on an intentional fraud or deliberate lies, but also on a negligent misrepresentation, as discussed above.[156] However, such instances are uncommon.[157]

MALICIOUS PROSECUTION, ABUSE OF PROCESS, AND INTENTIONAL INTERFERENCE WITH BUSINESS RELATIONS

The claims on which lender liability may be based are bounded only by the creativity of attorneys and the willingness of courts to countenance those displays of imagination.[158]

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misrepresentations over many months and the bank was aware it had put the plaintiff in a "huge financial predicament"); Delzer v. United Bank, 559 N.W.2d 531 (N.D. 1997) (punitive damages totaling $1,076,000 awarded against lender based upon a claim it breached its contract to lend money and a further claim of deceit); Ellerin v. Fairfax Sav., F.S.B., 652 A.2d 1117 (Md. 1995) (discussing the appropriate standard for the availability of punitive damages in a tort action of fraud or deceit).

[155] *See* Stirling v. Chemical Bank, 382 F. Supp. 1146 (S.D.N.Y. 1974) (shareholders had common law fraud cause of action against bank based on their reliance on lender's false representations that if they resigned their positions as officers and directors, outstanding loans would not be called and further loans would be made), *remanded and appeal dismissed*, 511 F.2d 1030, (S.D.N.Y.), *aff'd*, 516 F.2d 1396 (2d Cir. 1975); Krivo Indus. Supply Co. v. Nat'l Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973); Crystal Springs Trout Co. v. First State Bank, 732 P.2d 819 (Mont.) (bank liable to shareholders of debtor corporation where bank president misrepresented bank's intention to pursue long term financing for debtor and misrepresented availability of that financing), *modified*, 736 P.2d 95 (Mont. 1987). Third-party claims seeking to impose liability on lenders often arise in the context of a bankruptcy proceeding where the trustee or creditors seek to equitably subordinate lenders' claims. A detailed discussion of equitable subordination is included above.

[156] *See, e.g.*, Unicredito Italiano SPA v. JPMorgan Chase Bank, 288 F. Supp. 2d 485 (S.D.N.Y. 2003); *In re* Crown-Simplimatic Inc., 299 B.R. 319 (Bankr. D. Del. 2003); Blaine-Hays Constr. Co. v. Union Planter Nat'l Bank (*In re* Edgewater Motel, Inc.), 121 B.R. 962 (Bankr. E.D. Tenn. 1988) (lender liable for negligent misrepresentation to borrower regarding availability of sufficient funds to finance construction project), *appeal denied*, 876 F.2d 103 (6th Cir. 1989); Cypress Oilfield Contractors, Inc. v. McGoldrick Oil Co., 525 So. 2d 1157 (La. Ct. App.) (finding lender liable to third party based on the lender's negligent misrepresentation of borrower's financial stability), *cert. denied*, 530 So. 2d 570 (La. 1988). *But see* JP Morgan Chase Bank v. Winnick, No. 03 Civ. 8535 (GEL) 2004 WL 1418197 (S.D.N.Y. June 23, 2004) (negligent misrepresentation cause of action not available where lender made false statements because there was no "special" relationship between the lender and borrower); Birt v. Wells Fargo Home Mortgage, Inc., 75 P.3d 640, 657-58 (Wyo. 2003) ("negligent misrepresentation does not apply to misrepresentations of future intent or to statements of opinion").

[157] For example, under New York law, in the absence of a special relationship of trust or confidence, an action for negligent misrepresentation cannot be maintained. *See, e.g.*, Village on Canon v. Bankers Trust Co., 920 F. Supp. 520, 531 (S.D.N.Y. 1996); Sinclair Broadcast Group, Inc. v. Bank of Montreal, 1995 WL 70577 (S.D.N.Y. 1995); Official Comm. of Unsecured Creditors of Lois/USA, Inc. v. Conseco Fin. Serv. Corp., 264 B.R. 69 (Bankr. S.D.N.Y. 2001).

[158] *See, e.g.*, Cameo Dev. Co. v. Lakin (*In re* Cameo Dev. Co.), 2005 U.S. Dist. LEXIS 22311 (D. Ariz. 2005) (claims against lender included claims of intentional interference in contractual and business relationships and intentional infliction of emotional distress); Temp-Way Corp. v. Cont'l Bank, 139 B.R. 299 (E.D. Pa.) (claims against lender for business coercion and intentional interference with contractual relations), *aff'd*, 981 F.2d 1248 (3d Cir. 1992); Steele v. First Nat'l Bank, 136 B.R. 278 (D. Kan. 1991) (abuse of process claim against asserted against lender); Clemens v. West Milton State Bank (*In re*

For example, in *Paradise Hotel Corp. v. Bank of Nova Scotia,*[159] a secured lender terminated restructuring negotiations with its debtor and joined in filing an involuntary chapter 11 petition against it. After a plan of reorganization was confirmed, the debtor sued the secured lender alleging that because the lender had been fully secured, it was not authorized to file an involuntary petition[160] and had no reasonable grounds for believing that the debtor was not generally paying its debts at the time the petition was filed. The debtor asserted that this conduct constituted, among other things, malicious prosecution, abuse of process, and intentional interference with business relations.

The district court granted the lender's motion for summary judgment, and on appeal, the Third Circuit agreed that a secured lender may be a petitioning creditor to commence an involuntary case against a debtor. However, the court of appeals reversed the district court order with respect to the debtor's claims of malicious prosecution, abuse of process, and interference with business relations, summarily concluding that "we are unable to say that 'it appears beyond doubt that [the debtor] can prove no set of facts in support [of its claims] which would entitle [it] to relief.'"[161]

PRIMA FACIE TORT

A few states, most notably New York,[162] recognize a cause of action based on the so-called prima facie tort.[163] As stated in *Boatmen's Bank of Butler v. Berwald,*[164] the elements of the prima facie tort include:

Clemens), 197 B.R. 779 (Bankr. M.D. Pa. 1996 (lender liability action asserting numerous claims, including abuse of process and interference with prospective economic advantage), *vacated in part*, 225 F.3d 648 (3d Cir. 2000).

[159] 842 F.2d 47 (3d Cir. 1988).

[160] *See* 11 U.S.C. § 303(b)(1) (involuntary petition may be filed "by three or more entities, each of which is . . . a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute . . . if such noncontingent, undisputed claims aggregate at least $12,300 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims").

[161] 842 F.2d at 53 (citing Conley v. Gibson, 355 U.S. 41, 45-46 (1957)).

[162] *See* Nat'l Westminster Bank v. Ross, 130 B.R. 656, 686 (S.D.N.Y. 1991) (in a lender liability action, court noted that "New York permits recovery for prima facie tort upon a showing of malice and special damages") (citations omitted), *aff'd sub nom*. Yaeger v. Nat'l Westminster Bank, 962 F.2d 1 (2d Cir. 1992); *see also* Ibar v. Field, No. 97 Civ. 5211 (DC), 1998 WL 689953 (S.D.N.Y. Oct. 2, 1998) (noting that New York recognizes a claim for prima facie tort); Sharma v. Skaarup Ship Mgmt. Corp., 699 F. Supp. 440 (S.D.N.Y. 1988) ("For plaintiffs to recover for prima facie tort, they must allege and prove that defendants acted with 'exclusive malicious motivation.' 'The sole motivation for the damaging acts must have been a malicious intention to injure the plaintiff. Where there are other motives, such as profit, self-interest, or business advantage, there is no recovery under the doctrine of prima facie tort.'") (citing Marcella v. ARP Films Inc., 778 F.2d 112, 119 (2d Cir. 1985)), *aff'd*, 916 F.2d 820 (2d Cir. 1990), *cert. denied*, 499 U.S. 907 (1991); Rodgers v. Grow-Kiewit Corp., 535 F. Supp. 814, 816 (S.D.N.Y.), *aff'd*, 714 F.2d 116 (2d Cir. 1982). For further discussion see Kenneth J. Vandevelde, *A History of Prima Facie Tort: The Origins of a General Theory of Intentional Tort*, 19 HOFSTRA L. REV. 447 (1990).

an intentional unlawful act by the defendant;

an intent to cause injury to the plaintiff;

injury to the plaintiff; and

an absence of any justification or an insufficient justification for the defendant's act.

An analysis of these factors led the Missouri Court of Appeals to reverse a prima facie tort judgment entered against the lender because the plaintiffs "did not make a submissible case on each and every element."[165] However, the court did not rule out the prima facie tort theory in the lender liability context.

In *Berwald*, when the debtors experienced problems in their dairy operations, the bank agreed to lend additional funds to pay their other creditors. The bank subsequently advanced some, but not all, of the funds contemplated under the agreement. As their difficulties continued to mount, the debtors determined to enter into a federally funded bailout program. The bank required an assignment of the bailout payments in satisfaction of the debtors' outstanding indebtedness, but the debtors refused and the bank initiated replevin proceedings. Ultimately, the debtors paid a portion of their indebtedness to the bank out of the proceeds. When the debtors failed to complete payments, the bank sued to recover the outstanding balance. The debtors counterclaimed based on the prima facie tort. A jury returned a verdict in favor of the bank based on the amount outstanding on the note and in favor of the debtors for the bank's tortious conduct, the debtors being awarded the net amount of $100,000.

Although the court viewed the bank as insensitive to the problems of the debtors, it overturned the jury verdict, finding that the debtors failed to carry their heavy burden of proving actual intent to injure or exhibit malice. The debtors also failed to establish any facts to show that the demand for additional collateral was based on an unreasonable or unjustified feeling of insecurity. The debtors' assertion that they were current on their payments was not dispositive.

However, in *Indu Craft, Inc. v. Bank of Baroda*,[166] the United States Court of Appeals for the Second Circuit reinstated a $3,250,000 jury verdict in favor of the

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[163] *See, e.g.*, Schoen v. Morris, 15 P.3d 1094 (Colo. 2000); Selby v. Roggow, 975 P.2d 379 (N.M. Ct. App. 1999); Killion v. Bank Midwest, N.A., 987 S.W.2d 801 (Mo. Ct. App. 1998). *But see* Hughes v. Halbrach & Braun Indus., 10 F. Supp. 2d 491 (W.D. Pa. 1998) ("no plaintiff bringing suit under Pennsylvania law has ever recovered under a theory of prima facie tort") (quoting Charles Shaid of Penn., Inc. v. George Hyman Constr. Co., 947 F. Supp. 844 (E.D. Pa. 1996)).

[164] 752 S.W.2d 829 (Mo. Ct. App. 1988).

[165] *Id.* at 833.

[166] 47 F.3d 490 (2d Cir. 1995).

borrower on its claims for prima facie tort and breach of the implied duty of good faith. In that case, the borrower was a New York company in the business of importing women's clothing from Asia. In order to obtain letters of credit for its foreign suppliers, the borrower obtained a line of credit facility with an overdraft protection. For a three-year period after the opening of the credit line, the relationships between the borrower and the bank were informal. In some instances, the bank increased the borrowing capacity under the line of credit despite a decline in the borrower's sales or its inability to meet sales projections. On numerous occasions, the bank permitted the borrower to exceed its overdraft limit, sometimes by as much as forty percent. The bank typically issued letters of credit on behalf of the borrower within twenty-four hours of application.

Thereafter, an officer of the bank suggested that the president and sole stockholder of the borrower invest in a computer business for the benefit of the bank officer's son. When the borrower declined to make the requested investment, the bank demanded immediate reduction of the borrower's then-outstanding overdraft limit to the preset limit, and without prior notice, reduced the current limits under both the credit line and the overdraft facility. The bank's officer falsely informed the borrower that this reduction had been directed by the bank's central office in Bombay, India, when in fact, the central office knew nothing of the reduction. In addition, the bank imposed a new requirement on the borrower that all new applications for letters of credit be backed by confirmed orders notwithstanding that the bank was aware that due to the commercial practices in the industry, it was impossible for the borrower to comply with this requirement. Approximately one year after the bank had implemented these requirements, the borrower ceased its operations.

In an action for prima facie tort and breach of the duty of good faith and fair dealing implied in the loan documents, the jury returned a verdict for the borrower in an aggregate amount of $3,250,000, and further, excused the borrower from repaying approximately $1,700,000 remaining unpaid under the credit line. In a posttrial hearing, however, the trial court vacated the jury's award of all damages.

On appeal, the Second Circuit reinstated the jury award on all counts but upheld the bank's counterclaim against the borrower for the unpaid balance on the credit line. The appellate court held that the jury's finding that the bank had committed a prima facie tort was supported by ample evidence:

> The Bank and [its officer] engaged in deliberate delay in issuing letters of credit and made an unprecedented demand only on plaintiff that such letters be backed by confirmed orders from all of plaintiff's customers. Their conduct ultimately drove [the borrower] out of business. The jury was entitled to find that this web of wrongdoing was not woven by innocent hands. . . . *See* Freihofer v. Hearst Corp., 65 N.Y.2d 135, 142, 490 N.Y.S.2d 735, 480 N.E.2d 349 (Prima facie tort affords a remedy for "the infliction of intentional harm, resulting in damage, without excuse or

> justification, by an act or series of acts which would otherwise be lawful." (internal quotes omitted)).[167]

While the claim of prima facie tort may be asserted in lender liability litigation, this tort theory is not expected to evolve broadly as the doctrine is very narrowly construed in the few jurisdictions that allow such a claim.[168]

TORTIOUS INTERFERENCE WITH CONTRACTUAL RELATIONS

According to the *Restatement (Second) of Torts*:

> [O]ne who intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.[169]

Under this formulation, the elements of a claim for tortious interference with contractual relations consist of the existence of a contract, knowledge of the contract by the alleged interferer, the interferer's intentional or improper inducement of a party to breach the contract, and injury to the nonbreaching party.[170]

In *First Wyoming Bank, Casper v. Mudge*,[171] the sellers of the stock and assets of a business sued the buyer's lender alleging that the bank tortiously interfered with the contract of sale when it took a security interest in the buyer's assets. Included in the contract was a provision prohibiting the assets of the business from being "mortgaged for

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[167] *Id.* at 496-97. *But see* Maharaja Travel, Inc. v. Bank of India, No. 94 CIV. 8308 (KTD), 1997 WL 154044 (S.D.N.Y. Apr. 2, 1997) (trial court dismissed borrower's claim for prima facie tort allegedly arising from bank's refusal to advance funds under loan agreement because borrower could not establish bank's actions were motivated solely by malice); *see* Sharma v. Skaarup Ship Mgmt. Corp., 699 F. Supp. 440, 445-46 (S.D.N.Y. 1988) (failure to plead "exclusive malicious motivation" resulted in dismissal of claim of prima facie tort), *aff'd*, 916 F.2d 820 (2d Cir. 1990), *cert. denied*, 499 U.S. 907 (1991).

[168] 1-5 LENDER LIABILITY LAW AND LITIGATION (MB), *supra* note 152, § 5.02 ("Those jurisdictions allowing prima facie tort claims apply the doctrine very narrowly and often as a last resort to help an otherwise remediless plaintiff.").

[169] § 766 (1979); *see also* New Horizon Fin. Servs., L.L.C. v. First Fin. Equities, Inc., 175 F. Supp. 2d 348, 352 (D. Conn. 2001) (claim against lender for tortious interference with contractual relations sufficiently alleged where "impaired [the borrower's] ability to secure referrals for new business from third party vendors."); *In re* Kelton Motors, Inc., 1990 Bankr. LEXIS 1531 (Bankr. D. Vt. 1990) (complaint against lender alleged facts that brought it within the tort of interference with contractual relations).

[170] Some decisions (discussed below) have implicitly or explicitly added "lack of justification" for the interference as a fifth element necessary for a finding of tortious interference with contractual relations. *See, e.g.*, Cashback Liquidation Co. v. Tesler (*In re* Spree.Com Corp.), No. 00-34433DWS, 01-0161, 2001 WL 1518242 (Bankr. E.D. Pa. Nov. 2, 2001); *In re* Gettys, 205 B.R. 515, 520 (Bankr. S.D. Ohio 1997).

[171] 748 P.2d 713 (Wyo. 1988).

more than the presently existing indebtedness without Sellers' consent until the total purchase price herein agreed to be paid shall have been paid in full."[172] Almost immediately after the sale was closed, the buyer obtained a loan from the bank secured by the inventory sold pursuant to the agreement. No consent was received from the sellers. The buyer subsequently defaulted on the purchase payments to the sellers. After the sellers cancelled the contract, the bank initiated a foreclosure action on the inventory. The sellers posted a letter of credit to free the collateral and the bank foreclosed, drawing down the letter of credit.

The Wyoming Supreme Court upheld a judgment entered on a jury verdict in favor of the sellers on their claim of tortious interference. The court found that there was sufficient evidence in the record for the jury to conclude that the bank knew of the terms of the agreement before it took the security interest. In light of this knowledge, foreclosing on the collateral and requiring the seller to post a letter of credit "displayed a classic case of the tort of intentional interference with a contractual relation."[173]

Other courts also have demonstrated a willingness to hold lenders liable for tortiously interfering with contractual relations. In *Hold-Trade International, Inc. v. Adams Bank & Trust*,[174] a company in the business of processing beans borrowed $415,000 from a bank in order to pay farmers for unprocessed beans. The bank was granted a security interest in the borrower's equipment, machinery, inventory, and accounts receivable. The borrower advised the bank that it would repay the loan, in part, with monies received from customers that prepaid their processed bean orders. Shortly thereafter, the borrower informed the bank that it was experiencing unforeseen difficulties that caused it to fail to meet its contractual obligations to certain prepaying customers. Consequently, the bank requested and received permission from the borrower to apply all monies paid to the borrower at the bank to repay the loan.

Subsequently, a major customer paid the borrower $89,000 for a prior shipment of beans and those funds were applied by the bank to reduce the borrower's loan balance. The borrower then filled the customer's request for a large shipment of beans, even though the customer had not prepaid. The bank provided written approval or acknowledgment of the borrower's arrangement with the customer despite knowing that the orders of the prepaying customers had not yet been satisfied. The prepaying customers then filed a complaint asserting several causes of action, including tortious interference with contractual relations. In essence, the tortious-interference claim alleged

[172] *Id.* at 714-15.

[173] *Id.* at 717; *see also* Questar Pipeline Co. v. Grynberg, 201 F.3d 1277, 1284 (10th Cir. 2000) (following the holding annunciated in *First Wyoming*); Mark Gergen, *Tortious Interference: How It Is Engulfing Commercial Law, Why This Is Not Entirely Bad, and a Prudential Response*, 38 ARIZ. L. REV. 1175 (1996). *But see* Vescio v. Merchs. Bank, 272 B.R. 413 (Bankr. D. Vt. 2001) (claim of tortious interference with contractual relations denied where bank exercised its assignment of rents pursuant to a provision of a security agreement that plaintiff had voluntary entered into and was in default), *aff'd*, No. 01-5079, 2002 WL 31870212 (2d Cir. Dec. 20, 2002).

[174] 9 F.3d 1360 (8th Cir. 1993).

that by consenting to the borrower's shipment of beans to the customer, the bank interfered with the borrower's contracts with the prepaying customers by causing the borrower not to deliver their beans despite the bank's knowledge that they had prepaid.

The lower court rejected the tortious interference claim, holding that any interference by the bank was not the cause of the damages suffered by the plaintiffs because the borrower had never identified particular beans destined for the plaintiffs' contracts. The Court of Appeals for the Eighth Circuit, however, concluded that the district court's view of the causation requirement was too narrow. The court noted that there was conflicting evidence as to whether the borrower would have delivered the plaintiffs' beans if the bank had not interfered by supporting the customer's request to have its beans delivered before the plaintiffs' contracts had been satisfied.

Although the court of appeals did not hold that the bank was liable for tortious interference, it remanded the case to the lower court on that point and thereby indicated that the claims could be viable. However, in dictum that may provide some comfort to lenders, the court cited with approval a decision rendered by the Nebraska Supreme Court for the proposition that "only an 'unjustified' interference with contract is actionable" and that "[g]enerally speaking, a secured party is justified in interfering to protect a superior security interest."[175]

It also has been held that a lender may be liable for tortiously interfering with the economic relations between a borrower and a third party. In *Uptown Heights Associates Ltd. Partnership v. Seafirst Corp.*,[176] a principal sought bank financing for a joint venture with a developer that was a preexisting borrower from the bank. The developer filed a complaint against the bank alleging, among other things, that the bank made its loan to the principal contingent on the elimination of the developer's interest in the project and that the motive behind this contingency was the bank's desire to injure the business relations between the principal and developer to the detriment of the developer.

Although the trial court dismissed the claim, the Oregon Supreme Court reinstated it and found that the bank's act was similar to an act described in the *Restatement (Second) of Torts*[177] as illustrative of an action that would qualify as an intentional interference with performance of contract by a third person. The court relied on the comments to that section, which point out that although a party may refuse to contract with any other party for any reason whatsoever, that party may not use its refusal to deal as a form of affirmative inducement, compulsion, or pressure to cause a party to break its

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[175] *Id.* at 1365 (citing Cass Constr. Co. v. Brennan, 382 N.W.2d 313 (Neb. 1986)); *see also* Caven v. Am. Fed. Sav. & Loan Assoc., 837 F.2d 427, 432 (10th Cir. 1988); Ford v. C.E. Wilson & Co., 129 F.2d 614, 617 (2d Cir. 1942); GMAC Bus. Credit, L.L.C. v. Ford Motor Co. (*In re* H.S.A. II, Inc.), 271 B.R. 534, 543-44 (Bankr. E.D. Mich.) ("Generally speaking, a secured party is justified in interfering with a contract to protect a superior security interest."), *aff'd*, No. Civ. 02-70297, 2002 WL 32819769 (E.D. Mich. Sept. 30, 2002), *aff'd*, No. 02-2292, 2004 WL 1238881 (2d Cir. June 3, 2004).

[176] 891 P.2d 639 (Or. 1995).

[177] *Supra* note 169, § 766.

contract with a third party. Finding that the bank had refused to deal with the principal in order to coerce the principal into breaking its joint venture contract, the court remanded the matter for further proceedings on the issue of whether the bank was liable for tortious interference with economic relations.

BREACH OF CONTRACT

Several cases have addressed claims by borrowers based on a lender's refusal to fund. These cases usually involve a situation in which a lender withholds initial or additional financing either pursuant to a credit agreement or at least after extensive negotiations with the borrower have taken place.[178] For example, in *Penthouse International, Ltd. v. Dominion Federal Savings & Loan Ass'n,*[179] three weeks before a loan commitment expired, the lenders and the borrower held a preclosing meeting. At the meeting, the lead bank presented draft loan documents on preprinted legal forms with several unsatisfied closing conditions that necessitated, among other things, amendments to a lease. Through its outside counsel, the lender, which was not the lead bank but which had committed to provide $35,000,000 of the $97,000,000 loan, indicated that unless the closing conditions were met and the documents overhauled, it would not proceed. The lead bank then gave the lender responsibility for closing the deal. The lender subsequently gave the borrower a list of proposed amendments to the lease to make it comply with the closing conditions. As of the termination of the commitment period, however, certain closing conditions had not been met. Nevertheless, the parties continued to negotiate the terms of a loan, although the lender began "insisting" on new terms. The district court found that the lender's conduct, both before and after the commitment period expired, amounted to anticipatory repudiation of its commitment. The court found the lender liable for damages based on lost profits to the borrower in the amount of nearly $130,000,000 and to the lead lender in the amount of $7,700,000.

The United States Court of Appeals for the Second Circuit reversed the district court's decision and remanded with instructions to enter judgment in favor of the lender and its attorneys. The court held that because the commitment period had expired, the only relevant conduct cited by the district court as constituting anticipatory repudiation was the lender's proposed amendments. The court held that this conduct was not a " 'clear and unequivocal declaration' that performance would not be forthcoming," and further, that the lender's insistence on overhauling the deal to meet the closing conditions did not constitute anticipatory repudiation.[180]

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[178] To prevail on a breach of a commitment to fund action, a plaintiff must establish that an oral or written agreement to lend money existed. *See, e.g.*, Nat'l Farmers Org., Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984); Sterling Faucet Co. v. First Mun. Leasing Corp., 716 F.2d 543 (8th Cir. 1983) (preliminary commitment letter sufficient to find a binding obligation); Bohm v. Commerce Union Bank of Tennessee, 794 F. Supp. 158 (W.D. Pa. 1992).

[179] 665 F. Supp. 301 (S.D.N.Y. 1987), *aff'd in part, rev'd in part*, 855 F.2d 963 (2d Cir. 1988), *cert. denied*, 490 U.S. 1005 (1989).

[180] Oral agreements to extend financing may be enforceable, however, provided that testimony demonstrates that there was a meeting of the minds as to the material terms of the financing arrangement.

CONCLUSION

In reviewing this chapter, one might conclude that imposition of lender liability is widespread. That, however, is not true. Of late, particularly in the areas of equitable subordination and nonstatutory lender liability based on conduct, the pendulum has swung in favor of lenders, particularly at the appellate level. Nonetheless, lenders should be aware that the more control they have and exert over their borrowers, the more likely it is that they will be held liable under any number of theories. On the other hand, lenders should generally feel comfortable that they are unlikely to be exposed to liability if they abide by the express terms of their agreements with their borrowers, do not misrepresent facts to their borrowers or other parties, and recognize that their borrowers' property, even if that property constitutes the lenders' collateral, is not their own.

RESTATEMENT (SECOND) OF CONTRACTS §§ 26, 33 (1982); U.C.C. §§ 2-204(3), 2-305(1) (2001). Several cases have suggested that there may be circumstances where an oral commitment may be enforceable against a lender. *See* Baybank v. Vt. Nat'l Bank, 118 F.3d 30 (1st Cir. 1997); Landes Constr. Co. v. Royal Bank of Canada, 833 F.2d 1365 (9th Cir. 1987); Champaign Nat'l Bank v. Landers Seed Co., 519 N.E.2d 957 (Ill. App. Ct.), *appeal denied*, 530 N.E.2d 240 (Ill. 1988), *cert. denied*, 489 U.S. 1019 (1989). *But see* Homestead Golf Club, Inc. v. Pride Stables, 224 F.3d 1195 (10th Cir. 2000) (oral commitment to loan unenforceable because terms too incomplete); Mellon Bank Corp. v. First Union Real Estate Equity & Mortgage Invs., 951 F.2d 1399 (3d Cir. 1991) (parol evidence rule barred the introduction of an alleged oral agreement which directly contradicted the writings); Mark Andrew of Palm Beaches, Ltd. v. GMAC Commercial Mortgage, Corp., 265 F. Supp. 2d 366 (S.D.N.Y. 2003) (oral statements unenforceable because of the statue of frauds), *aff'd*, No. 03-7801, 2004 WL 860161 (2d. Cir. Apr. 22, 2004).