Critical Concepts for Avoiding Lender Liability (What All Lenders Should Know)

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Fact Pattern

Since its inception in 2001, Shearling Coopmer ("S&C") has grown to be a very promising and innovative advertising and marketing firm. S&C's Chief Executive Officer, Roger Shearling, pretty much does nothing but drink martinis and smoke all day to earn his $100,000 annual salary, but led by its Chief Creative Officer, Dom Draker, S&C has grown from its inception with 4 employees and $200,000 per year of revenue, to 30 employees with $3 million in annual revenue. The firm prides itself on creativity and its fast growth. Much of S&C's growth came as a result of one client, 7 Hour Energy, which marketed a natural stimulant product to help sleep deprived and overworked professionals, travel sport parents and party animals. S&C's revenues were flat at $500,000 from 2002-2005. However, in 2005 Dom created a blitz ad campaign for a then-small company known as "20 Minute Energy", suggesting they radically change their name, and the rest was history.

In the process of growing, S&C lined up a $2 million secured revolving loan from one of its other clients, Heidelberg Bank. Although S&C was shopping several different lenders, S&C became impressed with Heidelberg Bank during the course of developing Heidelberg's famous "Bank that Knocks" campaign. Heidelberg Bank's loans primarily are handled by its sole origination and special assets officer, Walter Wise.

In 2014, 7 Hour Energy decided to mix it up and began assigning projects to another advertising agency it used previously for one project, McCabb, based on McCabb's brilliant TV ad "I'd like to Buy The World a 7 Hour Energy". Walter Wise, after reading news reports noting the loss of business, scheduled meetings with S&C. In the meetings, Walter Wise was furious and insisted that S&C would need significant and immediate additional revenue to fill the hole in its cash flow or Heidelberg would cease funding. Meanwhile, Dom Draker argued that S&C would hit a home run and should invest some of its scant available funds to hire a bright, rising star account executive, Peggy Holsen, who did some work for Pepsi and whom Dom believed was on the verge of obtaining more significant and lucrative projects from Pepsi. Bert Coopmer, the other named partner of S&C, argued that the firm could right the ship with 7 Hour Energy and he would meet with 7 Hour to obtain additional business. Roger Shearling poured himself a martini.

After the meeting with Heidelberg Bank, S&C's leadership decided to hire Peggy Holsen immediately and S&C signed a contract to employ her. However, three days after the meeting, S&C's financial reports showed it suffered a significant hit to its revenues such that it would struggle to keep up with its loan payments and was teetering on default. Wise believed that S&C would be better off not hiring Peggy Holsen and instead trying to win more business from 7 Hour Energy, although he had not come to a final decision on that issue. Nonetheless, based upon how grim S&C's financial picture was looking in the long term, citing a provision of the loan agreement that allowed Heidelberg Bank to stop providing money if it deemed itself insecure of repayment, Wise told S&C that Heidelberg Bank would cease lending imminently and would not allow S&C to borrow the additional funds incrementally needed to hire Holsen. Wise demanded that, instead of hiring Holsen, S&C fire Shearling for not managing the business responsibly and install a consultant, Jesse Pinkman, to help manage cash. Pinkman had helped Heidelberg successfully navigate several workouts and turnarounds in the past, that is, until his most recent deal, during the course of which Pinkman's behavior became erratic and he sometimes miscalculated critical figures uncharacteristically. Wise advised S&C's management that Pinkman was "one of our best guys – really sharp and he will help you with your financials". Wise insisted that Jesse Pinkman and Bert Coopmer meet with 7 Hour Energy to attempt to secure more business. After much hand-wringing and several bourbons, S&C complied with Wise's request, seeing no other alternatives. Dom Draker disappeared without resigning, never to be seen again in this fact pattern.

Of course, S&C's efforts failed, and S&C filed a voluntary petition for relief under chapter 7. What issues do you see from the lender's and borrower's perspectives and specifically:

[Lack of Good Faith in Wielding the Insecurity Clause

Interference with Contract on Peggy Holsen Contract

Fraudulent Misrepresentation on Pinkman AND on decision to stop funding

Duress

Lack of Documentation Protecting the Lender on Decisions

Equitable Subordination – probably a loser for debtor]

(1) how could they have been addressed differently in the past and

(2) how should they be addressed in the chapter 7 case?

Certain Bankruptcy Considerations

for

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American Bankruptcy Institute Central States Bankruptcy Workshop
Traverse City, MI
June 11 – 14, 2015

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April 24, 2015

I. INTRODUCTION

When a debtor files a petition in bankruptcy, what simply was a bad loan or a credit dispute becomes – literally – a "federal case." New rules (the Bankruptcy Code (11 U.S.C. §§ 101, *et seq*.) and the Federal Rules of Bankruptcy Procedure) and new parties (bankruptcy judges, trustees and others) now govern which creditors will be paid, and how much. Creditors who understand and follow the rules that apply to bankruptcy cases stand a much better chance of recovering some portion of what they are owed; those who ignore them risk losing their claim altogether. Given that bankruptcy is now a fact of modern business life, creditors are wise to learn the basics of how to limit the damage when a debtor files bankruptcy.

The following discussion addresses certain of the special hazards that the bankruptcy of a borrower can pose for a lender, under the general rubric of "lender liability."

II. "TOTO, WE'RE NOT IN KANSAS ANYMORE": THE STRANGE AND (SOMETIMES) DANGEROUS WORLD OF BANKRUPTCY

A. How Bankruptcy Changes the Equation for Lenders

Workout negotiations often resemble a game of "five card stud" poker, in which either party may threaten (overtly or covertly) to play the "bankruptcy card." Nothing is more satisfying than to meet your opponent's "last and best offer" with the simple reply, "see you in bankruptcy court." Many times a borrower's financial circumstances leave bankruptcy as the only (and best) option for both borrower and lender. Before taking steps that inevitably may force the borrower's bankruptcy, however, a savvy lender will consider what a bankruptcy filing at this time might mean for the lender's claims against the borrower, and – potentially – *vice versa*.

Bankruptcy is not necessarily a bad thing for a lender. Indeed, given that in bankruptcy a lender's dealings with the borrower and the collateral are governed by the Bankruptcy Code, and ultimately are subject to court review and approval, bankruptcy can be seen as a "safe haven" for the collection or workout of the lender's loans.[1] Bankruptcy's potential benefits for the lender can include the following:

(1) Restriction on borrower's use of property: The ability of the bankruptcy trustee or the debtor-in-possession's ("DIP")[2] to use, sell or lease property is restricted to transactions in the "ordinary course of business," *see* 11 U.S.C. §363(c);

(2) Restriction on borrower's use of cash collateral: The DIP cannot use a lender's cash collateral[3] without either the lender's consent or court approval, *see* 11 U.S.C. §363(c)(2);

(3) Restriction on borrower's ability to incur additional debt: The DIP can only incur debt on an unsecured basis and in the ordinary course of business without court approval -- any other postpetition financing (such as on a secured or priority basis) must be approved by the court, *see* 11 U.S.C. §§ 364(a), (c) & (d);

(4) Lender has no further obligation to extend credit: The lender cannot be forced to

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1 David C. Hillman & Matthew L. Caras, *When the Bank Wants its Borrower in Bankruptcy: Benefits of Bankruptcy for Lenders and Lender Liability Defendants*, 40 Me.L.Rev. 375, 385 (1988).

2 In a Chapter 11 case, the debtor – the "debtor-in-possession" – is permitted to remain in possession of, and continue to operate, its business with existing management, subject to minimal supervision by the Court and the Office of the U.S. Trustee, an officer of the U.S. Department of Justice. *See* 11 U.S.C. §1107(a).

3 "Cash collateral" is defined by the Bankruptcy Code as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired . . . and includes the proceeds, products, offspring, rents or profits of property . . . " 11 U.S.C. §363(a). The most usual type of cash collateral with which lenders are concerned is the cash received by a borrower upon the collection of accounts receivable.

continue to extend loans or credit to the debtor, *see* 11 U.S.C. §§ 365(c)(2) & (e)(2)(B);

(5) Borrower's officer's salaries are subject to review: The reasonableness of the salaries paid to the borrower's officers is subject to review by the U.S. Trustee, any committee of unsecured creditors (the "Creditors' Committee") appointed in the case, and ultimately the court;

(6) Financial reporting requirements: The borrower's financial reporting may improve, because the DIP is required to file with the U.S. Trustee monthly reports of, *inter alia*, receipts and disbursements (i.e., cash flow statements) and profit and loss reports, *see* 11 U.S.C.§ 704(8);

(7) "Adequate protection" of lender's interest in collateral can be required: The DIP can be required to provide the lender with "adequate protection" of the lender's interests in collateral (including the use of cash collateral) as, essentially, the "price" for the lender's continued forbearance from foreclosure, *see* 11 U.S.C. §§ 361 & 362(d)(1) and *United Sav. Ass'n v. Timbers of Inwood Forest,* 484 U.S. 365 (1988);

(8) One forum for resolution of disputes: Generally, *all* of the DIP's disputes can be resolved in one forum, the Bankruptcy Court, as opposed to disparate courts in far-flung jurisdictions, *see* 28 U.S.C. §§ 157, 1334, 1408 & 1409;

(9) Greater leverage over borrower's reorganization (or liquidation): Through Chapter 11's plan confirmation process, bankruptcy offers a lender the potential

to gain leverage over junior secured creditors, unsecured creditors or equity holders who seek to thwart the DIP's reorganization, *see*, *e.g.*, 11 U.S.C. §1129;

(10) Borrower's ability to shed burdensome leases and contracts: The DIP can reject burdensome leases and executory contracts, *see* 11 U.S.C. §365;

(11) Borrower's ability to recover fraudulent and preferential transfers: The DIP can recover prebankruptcy fraudulent and preferential transfers, *see* 11 U.S.C. §§ 544(b), 547, 548 & 550; and

(12) Suitable forum for borrower's orderly liquidation: If attempts at reorganization fail, bankruptcy offers the opportunity for an orderly liquidation under Chapter 7.[4]

While bankruptcy thus can serve as a shield for lenders, it may also become a sword against them. Bankruptcy also has its own set of dangers for lenders, and these cannot be ignored. These dangers can include the following:

(a) Risk of equitable subordination: Under appropriate circumstances, a Bankruptcy Court can "equitably subordinate" a lender's claim to those of other creditors or shareholders, thereby potentially reducing (or even eliminating a lender's recovery. Valid contractual subordination agreements also are enforceable in bankruptcy. *See* 11 U.S.C. §510;

(b) Risk of preference or fraudulent transfer attack: Under certain circumstances, the DIP (or a Creditor's Committee) can set aside prebankruptcy transfers of property

[4] *See generally* Hillman & Caras, *supra*, 40 Me.L.Rev. 375.

or interests in property (including the granting of security interests) as preferences or fraudulent transfers, *see* 11 U.S.C. §§ 544(b), 547, 548 & 550; and

(c) Increased likelihood that "lender liability" claims will be pursued: The usually supercharged atmosphere of bankruptcy, coupled with the fiduciary duties that the DIP owes to its creditors[5], may force a DIP to pursue "lender liability" claims against a lender that a borrower may have been willing to ignore outside of bankruptcy. Even if the DIP declines to purse such claims (or is precluded from doing so by the terms of any postpetition cash collateral or financing arrangements), a Creditors' Committee may obtain authority to do so. *See* 11 U.S.C. §1103(c)(2) & (5).

The "bottom line," then, is that bankruptcy poses potential benefits and risks to a lender, depending upon the facts and circumstances of each case. Once a bankruptcy is filed, a lender's conduct towards a borrower may be subject to public review by any number (or combination) of the players in a bankruptcy case.

B. Risks of Filing an Involuntary Bankruptcy

1. Reasons to Do It

a. Overview

As noted above, often it is not in the interest of a lender to place its borrower in bankruptcy. As a collection device, involuntary bankruptcy clearly is a last resort. However,

[5] *See, e.g.*, Daniel B. Bogart, "Liability of Chapter 11 Debtors in Possession: 'Don't Look Back – Something May be Gaining on You,'" 68 Am.Bankr.L.J. 155, 216 (1994).

there are circumstances where an involuntary bankruptcy represents a lender's last best hope for receiving some payment on a debt. The reasons for "pulling the plug" are discussed below.

b. Preserve assets for unsecured creditors

Frequently, debtors hovering on insolvency pay "friendly" creditors to the exclusion of "unfriendly" creditors, convey their property in "sweetheart deals" to their friends or business associates, and/or dump their property at "fire sale" prices in an effort to raise ready cash. Where this is occurring, often the best way for unsecured creditors to preserve something of value among the debtor's assets is by filing an involuntary bankruptcy case against the debtor.

(1) Use of trustee's broad avoidance powers

The Bankruptcy Code authorizes a bankruptcy trustee or DIP to bring several avoidance actions to recover assets for the benefit of the debtor's creditors; this is one of the "carrots" which induces unsecured creditors to file an involuntary petition. Certain of these avoidance actions have relatively short "reach-back" periods, i.e., the period during which prebankruptcy transactions can be set aside. Chief among these avoidance actions are preferential transfers, 11 U.S.C. §547, which has a 90-day reachback period as to noninsiders (and a one-year reachback period as to insiders), and fraudulent transfers, 11 U.S.C. §548, which has a one-year reachback period. Additionally, the trustee may pursue fraudulent transfers under a state's fraudulent transfer laws (such as the Uniform Fraudulent Transfer Act, *see, e.g.*, Ind. Code §§ 32-18-2-1 *et seq*.) pursuant to 11 U.S.C. §544(b); the statute of limitations for such actions usually is four (4) years, although this period can be extended – in the case of intentional fraudulent transfers – for up to one (1) year from the point the transfer was, or reasonably could have been, discovered.

See, *e.g.*, Ind. Code § 32-18-2-19(1).

Under the Bankruptcy Code, the avoidance reachback periods are calculated from the filing of the bankruptcy petition. *See*, *e.g.*, 11 U.S.C. §§ 547(b)(4) (preferences) & 548(a) (fraudulent transfers). This can include the filing of either a voluntary or an involuntary petition. *See* 11 U.S.C. §§ 301 (voluntary cases) & 303(b) (involuntary cases). Thus, filing an involuntary petition prior to the expiration of these reachback periods preserves the trustee's (or DIP's) ability to set-aside avoidable prepetition transfers. In evaluating whether (and when) to file an involuntary bankruptcy, a lender should analyze, *inter alia*, what exposure (if any) the lender itself may have for avoidable prepetition transfers.

(2) Imposition of automatic stay

Under 11 U.S.C. §362(a) the filing of a petition in bankruptcy acts as an automatic stay of, among other things, any efforts by a creditor to enforce its claims against the debtor or the debtor's property. Invocation of the automatic stay by filing an involuntary petition thus is another "carrot," for the effect of the automatic stay is to prevent any further depletion of the debtor's estate by the judgment enforcement activities of other creditors.

(3) Ousting ineffective or incompetent incumbent management

Ousting ineffective or incompetent incumbent management of a debtor corporation can be another goal of an involuntary bankruptcy, although it can be frustrated if the corporate debtor files a superseding voluntary Chapter 11 petition.

2. Risks

An exhaustive survey of the law of involuntary bankruptcy is beyond the scope of this paper, but a few salient issues should be discussed. The filing of an involuntary bankruptcy case is a drastic measure, and any creditor considering filing an involuntary bankruptcy petition must thoroughly analyze whether all of the Bankruptcy Code's prerequisites can be met. Indeed, the old saw about the risks of cross examination on grounds of bias applies equally to the filing of an involuntary bankruptcy petition, namely "if you shoot the king, shoot to kill."

Filing an involuntary bankruptcy petition essentially commences a lawsuit against the putative debtor, with the issue for trial being whether the debtor is insolvent. If the petitioning creditors lose this trial, they are liable for the debtor's costs and attorneys' fees. 11 U.S.C. §303(i)(1). If the Bankruptcy Court finds that the petitioning creditors filed the petition in bad faith, they also can be liable for any damages proximately caused by the filing, or punitive damages. 11 U.S.C. §303(i)(2).[6] In addition, the unsuccessful petitioning creditors may face civil liability for malicious prosecution, abuse of process and intentional interference with business relations. *See Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 52 (3rd Cir. 1988). It should be noted in this regard that merely threatening to file an involuntary petition is dangerous, for it may constitute extortion under applicable state law, a federal bankruptcy crime

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[6] In *DVI Receivables XIV v. Rosenberg (In re Rosenberg)*, 779 F.3d 1254, 1269 (11th Cir. 2015), the 11th Circuit held that pursuant to 11 U.S.C. §303(i), a creditor which files an involuntary bankruptcy petition that eventually is dismissed can be held liable for the putative debtor's attorneys' fees incurred in fighting the involuntary petition, as well as the putative debtor's attorneys' fees sustaining the dismissal on appeal, and the putative debtor's attorneys' fees incurred in pursuing a separate claim (in an adversary proceeding) for damages resulting from the bad-faith filing. Similarly, in *Basin Elec. Power Co-op. v. Midwest Processing Co.*, 769 F.2d 483 (8th Cir.), *cert. denied*, 474 U.S. 1083 (1986), the petitioning creditor knew that the debtor had more than twelve eligible creditors, but the creditor filed a single creditor involuntary petition in order to gain an advantageous position under a letter of credit by triggering a default thereunder. The petitioning creditor was held liable for filing a defective involuntary petition in bad faith. *Id*. at 485-87.

under 18 U.S.C. §152 (obtaining or attempting to obtain money for forbearing from acting in a case under the Bankruptcy Code), and evidence of "bad faith" if the involuntary petition is later dismissed.

III. EQUITABLE SUBORDINATION

A. Overview

Accurately viewed, equitable subordination as applied to lenders is not a separate species of lender liability, but rather a remedy applied for lender misconduct resulting in the subordination, or reordering of priority, of the lender's claim in a bankruptcy case.[7]

Bankruptcy courts, as courts of equity, long have exercised the power to subordinate claims. *See, e.g., Pepper v. Litton*, 308 U.S. 295, 308-09 (1939) ("[i]n the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate"; thus, a bankruptcy claimant occupying a fiduciary position could not use that position for his own advantage). That power now is codified in 11 U.S.C. §510(c), which provides that

> [A]fter notice and a hearing, the court may--
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

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[7] Patrick A. Murphy & Margaret Sheneman, *The Resolution and Preclusion of Lender Liability Claims in Bankruptcy Cases,* C610 ALI-ABA 389, 413 (February 28, 1991).

11 U.S.C. §510(c). By its terms, §510(c) does not address the total disallowance of a claim, but rather only its priority.[8] While the Bankruptcy Code recognizes equitable subordination, §510(c) provides no guidance in its application, instead leaving this to caselaw development. In this regard, although two decisions of the Supreme Court of the United States, *United States v. Reorganized CF&I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S.Ct. 2106, 135 L.Ed.2d 506, 519 (1996) and *United States v. Noland*, 517 U.S. 535, 116 S.Ct. 1524, 134 L.Ed.2d 748 (1996), together held that bankruptcy courts cannot categorically subordinate a tax penalty claim simply by virtue of its status as a penalty,[9] they expressly did not decide whether creditor misconduct is required for subordination under 11 U.S.C. §510(c).[10]

Although the doctrine of equitable subordination is considered to be remedial, as opposed to penal, its application in a bankruptcy context often can work a harsh result because a change in a creditor's priority may mean that the creditor will receive nothing after its claim is subordinated.[11] For this reason, equitable subordination ""is an unusual remedy which should be applied in limited circumstances,"[12] and traditionally has been ordered only upon a showing that "the claimant creditor engaged in inequitable conduct that injured other creditors or conferred an

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8 *See In re Mobile Steel Co*., 563 F.2d 692, 699 (5th Cir. 1977); *In re 80 Nassau Assocs*., 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994).

9 Peter A. Christou, Note, "Federal Tax Claims in Bankruptcy and the Doctrine of Equitable Subordination: *United States v. Noland* and *United States v. Reorganized CF&I Fabricators of Utah, Inc.*," 50 Tax Law. 237, 245 (1996).

10 *See Noland*, 134 L.Ed.2d at 756. Instead, the Court merely stated that "the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Bankruptcy Code." *Id.* In other words, subordination must be justified by specific facts, not by the nature of the claim.

11 Robert F. Finke, Stuart M. Rozen and Robert H. George, *Undoing the Excesses of the 1980s: Avoidance Actions and Equitable Subordination*, C880 ALI-ABA 197, 335-36 (1994).

12 *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 745 (6th Cir. 2001)(internal citations omitted); *Webster v. Barbara (In re Otis & Edwards, P.C.)*, 115 B.R. 900, 914 (Bankr. E.D. Mich. 1990) ("a remedy rarely used by the courts")

unfair advantage on the claimant, but not when subordination is inconsistent with the Bankruptcy Code." *In re Sentinel Mgmt. Group, Inc.*, 728 F.3d 660, 669 (7th Cir. 2013); *see AutoStyle Plastics, supra*, 269 F.3d at 744 ("(1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act" (citations omitted). Indeed, "[e]ven when the standard for equitable subordination has been met, courts may, but are not bound, to impose such a remedy." *Bash v. Fortress Credit Corp. (In re Fair Finance Co.)*, 2014 WL 7642447, *19 (Bankr. N.D. Ohio 2014)(citations omitted).

Application of the doctrine of equitable subordination "allows the bankruptcy court to reprioritize a claim if it determines that the claimant is guilty of misconduct that injures other creditors or confers an unfair advantage on the claimant.'" *Sentinel Mgmt., supra,* 728 F.3d at 669 (internal citations omitted). In order for this remedy to be applied, "the party against whom equitable subordination is sought [must] have filed a proof of claim . . . . [a]bsent the filing of a proof of claim, there is no claim for the district court to equitably subordinate." *Fair Finance, supra*, 2014 WL 7642447, *19-20.[13]

According to the Seventh Circuit, "[t]ypically, the misconduct that courts have deemed sufficiently inequitable to merit this remedy has fallen within one of three areas: . . . '(1) fraud, illegality, breach of fiduciary duties; (2) under-capitalization; [or] (3) claimant's use of the debtor as a mere instrumentality or alter ego.'" *Sentinel Mgmt., supra,* 728 F.3d at 669 (citations

[13] Presumably, this proof of claim filing requirement would be deemed satisfied in circumstances where no proof of claim is required, such as in a Chapter 11 case where a creditor's claim that has not been scheduled as contingent, unliquidated or disputed is "deemed filed under section 501." *See* 11 U.S.C. §1111(a) and Fed.R.Bankr.P. 3003(c)(2).

omitted). Application of equitable subordination "'means that a court has chosen to disregard an otherwise legally valid transaction.'" *Id*. For this reason, most courts have "treaded very carefully before [invoking equitable subordination to] disregard[] an otherwise legally valid transaction," due to "[t]wo fundamental concerns," namely "(1) the upsetting of a claimant's legitimate expectations, and (2) the spawning of legal uncertainty that courts will refuse to honor otherwise binding agreements 'on amorphous grounds of equity,' increasing everyone's credit costs." *Id* (citing *In re Lifschultz Fast Freight*, 132 F.3d 339, 347 (7th Cir. 1997)).

The Seventh Circuit in *Sentinel Mgmt.* cited the potential proof problems inherent in pursuing equitable subordination of a claim as another brake on a court's ability to impose this remedy:

> [T]he difficulty of proving that a creditor has engaged in inequitable behavior has further increased our hesitance to apply the doctrine of equitable subordination. For example, the question of " 'whether a party has acted opportunistically,' " is quite subjective. There are simply no clear rules for determining whether underhanded behavior occurred. ("Equitable subordination relies on courts' peering behind the veil of formally unimpeachable legal arrangements to detect the economic reality beneath."). Underhanded behavior is typically clearest, however, when "corporate insiders [have attempted] to convert their equity interests into secured debt in anticipation of bankruptcy." Consequently, courts have most frequently invoked this doctrine against corporate insiders, requiring them "to return to their position at the end of the line.".
>
> Proving that an outside creditor behaved inequitably in anticipation of the debtor's bankruptcy is much more difficult; the interests of an outside creditor are not necessarily aligned with the interests of the debtor (or with the interests of the debtor's shareholders). As a result, courts have been particularly hesitant to invoke the doctrine of equitable subordination outside of cases involving insiders of closely held corporations. Some bankruptcy courts have even required wrongful conduct that rises to the level of "gross and egregious," "tantamount to fraud, misrepresentation, overreaching or spoliation," or "involving moral turpitude" before equitably subordinating an outside creditor's claim. Consequently, it is not surprising that "[c]ases subordinating the claims of creditors that dealt at arm's length with the debtor," such as the case at hand, "are few and far between."

Sentinel Mgmt., *supra*, 728 F.3d at 669-70 (internal citations omitted).[14]

The burden of establishing all of the elements of equitable subordination under 11 U.S.C. §510(c), by a preponderance of the evidence, rests on the objecting party. *Official Comm. of Unsecured Creditors v. Liberty Savings Bank, FSB (In re Toy King Distrib., Inc.)*, 256 B.R. 1, 205 (Bankr. M.D. Fla. 2000). Once this initial burden is met, the burden then shifts to the creditor to demonstrate its good faith and the fairness of its conduct. *Fabricators, Inc. v. Technical Fabricators, Inc. (Matter of Fabricators, Inc.)*, 926 F.2d 1458, 1465 (5th Cir. 1991).

It is worth noting that because equitable subordination is a remedy that stems from §510(c) of the Bankruptcy Code, it has no application outside of a bankruptcy case – at least in Indiana. In *PCL/Calumet v. EnterCitement, LLC*, 760 N.E.2d 633 (Ind. Ct. App. 2001), *trans. denied*, 783 N.E.2d 697 (Ind. 2002), the Indiana Court of Appeals held that "[a]s recognized by a panel of this court, reliance on this doctrine [of equitable subordination] in a priority dispute unrelated to a bankruptcy proceeding is unwarranted because all three of the conditions that must be met [citing *Lifschultz*, *supra*, 132 F.3d at 342-43] in order for the doctrine to apply 'hinge in great part upon the Bankruptcy Code itself.'" *EnterCitement* at 640, *citing First Bank of Whiting v. Samocki Bros. Trucking Co.*, 509 N.E.2d 187, 197-98 (Ind. Ct. App. 1987). Accordingly, *EnterCitement* held that the equitable subordination arguments of the parties in that case could be ignored. *Id.*

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[14] Significantly, in *Lifschultz* the Seventh Circuit noted in a footnote that "[w]e are aware of no case in which this circuit has approved of the equitable subordination of a secured claim absent inequitable conduct …" *Lifschultz, supra*, 132 F.3d at 349 n. 11.

B. Equitable Subordination of Lenders' Claims

As the Seventh Circuit noted in *Sentinel Mgmt.*, the remedy of equitable subordination most often has been applied to shareholders, other insiders of the debtor and those with well-recognized fiduciary duties to the debtor.[15] *See Sentinel Mgmt.*, *supra*, 728 F.3d at 669. *See also Fabricators, supra*, 926 F.2d at 1465. Indeed, the Seventh Circuit observed in *Sentinel Mgmt.* that "[i]n the past, our court has not directly addressed the degree of wrongful conduct sufficient to invoke the doctrine of equitable subordination against an outside creditor," noting that the district court below in *Sentinel Mgmt.* had "looked to decisions outside our circuit" to determine that "equitable subordination would be inappropriate in this case unless the [lender's] behavior had been 'egregious and conscience shocking.'" *Sentinel Mgmt.*, *supra*, 728 F.3d at 670.

Sentinel Mgmt. represents yet another vignette of the fallout from the Great Recession. The facts in this case are complex; boiled to their essence, Sentinel Management was an investment manager for futures commission merchants ("FCMs") in the commodities industry, and by 2007 held over $1.5 billion in customer funds, which were required by the Commodity Exchange Act, 7 U.S.C. §§ 1, *et seq*., to be held in segregated accounts; Sentinel Management maintained only $3 million or less in net capital. Sentinel Management also served other investors such as hedge funds and commodity pools, and as early as 2005, began maintaining a house account for its own trading activity to benefit Sentinel Management insiders. Despite the account segregation requirement and Sentinel Management's representations to the contrary, Sentinel Management handled its own, and its customers' assets "'as a single, undifferentiated pool of cash and securities.'" *Sentinel Mgmt., supra*, 728 F.3d at 662-63.

[15] *See further* Finke, Rozen and George, *supra* note 10, C880 ALI-ABA at 339.

Sentinel Management financed its activities with the Bank of New York Mellon ("Bank"), under a facility that by 2007 had been amended to allow Sentinel Management to pledge some customer funds to secure short-term borrowing from the Bank. With the onset of the Great Recession, Sentinel's pledges of customer funds steadily increased, so that by its August 17, 2007 Chapter 11 filing, it owed the Bank more than $312 million. *Id*. at 663-66.

Following Sentinel Management's filing, a Chapter 11 trustee was appointed who eventually filed an adversary proceeding against the Bank seeking, *inter alia*, to equitably subordinate the $312 million secured claim the Bank filed on the grounds that when accepting additional collateral for its loans during the prebankruptcy period, the Bank knew about Sentinel Management's fraudulent use of customer assets to finance the loans to cover Sentinel Management's house trading activity. *Id*. at 666. Following a 17-day bench trial, the district court rejected the Chapter 11 trustee's claims because the court did not believe the Bank's conduct was "'egregious or conscience shocking,'" and further found that the Bank's employees "'had no legal obligation . . . to seek out or analyze the data' that would have revealed Sentinel[Management]'s misuse of the segregated funds." *Id*. (internal citations omitted).

The Seventh Circuit reversed the district court on its equitable subordination ruling and remanded for further clarification of its conclusions, holding that in rejecting the Chapter 11 trustee's equitable subordination claims, "the district court relied upon factual findings that were internally inconsistent." *Id*. at 670[16]. Specifically, the Court stated "the district court appears to

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[16] Interestingly, the Court's original opinion in *Sentinel Mgmt.* affirmed the district court in all respects, with the Court stating "[t]his appeal raises concerns about Sentinel's business practices and the degree to which the bank knew about them, but based on the district court's factual findings, we affirm," *In re Sentinel Mgmt. Group, Inc.*, 689 F.3d 855, 858 (7th Cir. 2012), *opinion withdrawn and vacated by In re Sentinel Mgmt. Group, Inc.*, 728 F.3d 660 (7th Cir. 2013), but the Court withdrew and vacated this prior opinion, without comment, by its 2013 opinion in this case, found at 728 F.3d 660.

contradict itself regarding the extent of the Bank's knowledge before Sentinel's collapse," citing the district court's finding that "'[T]he evidence at trial revealed the Bank's knowledge that Sentinel insiders were using at least some of the loan proceeds for their own purposes'" – characterizing this as a finding "indicat[ing] that the Bank [] knew Sentinel was engaging in wrongful conduct before the collapse" – and contrasting that with the district court's later finding that "I do find credible, if not at all admirable, the testimony of the Bank employees that they neither knew nor turned a blind eye to the improper actions of Sentinel" – commenting that this "make[s] no sense" in light of the prior finding, because "[i]f the Bank knew that Sentinel insiders were misusing the loan proceeds, then how could it be the case that bank employees 'neither knew nor turned a blind eye to the improper actions of Sentinel'?". *Id* at 670. Accordingly, the Seventh Circuit asked the district court on remand to "clarify two critical issues," namely (1) what did the Bank know before Sentinel Management's collapse, and did it know that Sentinel Management was engaged in misconduct of any kind (including abuse of the loan proceeds), and (2) was the Bank's failure to investigate Sentinel Management before its collapse merely negligent, or was it reckless or deliberately indifferent. *Id*. at 672. The Seventh Circuit noted that "[o]nce the district court clarifies these two points on remand, it can then revisit the ultimate issue of whether the Bank's claim merits equitable subordination." *Id*. Thus, we may have to wait for a possible future *Sentinel Mgmt. II* for the definitive word from the Seventh Circuit as to what types of alleged lender misconduct in the context of a borrower's slide into bankruptcy warrant equitable subordination of the lender's secured claims.

In the meantime, for noninsiders, the party seeking subordination must provide evidence of more egregious conduct on the part of the creditor such as fraud, spoliation or overreaching is necessary, and must prove it with particularity.[17] *Fabricators, supra*, 926 F.2d at 1465*; In re N & D Prop., Inc.*, 799 F 2d 726, 731 (11th Cir. 1986). Generally speaking, if the defendant is not an insider or some other fiduciary, the creditor is entitled to protect its interests – to the detriment of other creditors – without risking subordination of its claim.[18]

In addition to *Sentinel Mgmt.*'s pronouncements on the subject, it appears that other courts have applied equitable subordination to non-insiders in two broad categories of cases: those in which the non-insider effectively controls the debtor to the disadvantage of others, and those in which the non-insider defrauds other creditors.[19] For lenders, the most frequently-used basis for seeking equitable subordination is that the non-insider's control over the borrower is so extensive as to make the lender a *de facto* insider:[20]

> A lender . . . will usually possess "control" in the sense that it can foreclose or drastically reduce the debtor's financing. 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 to have essentially replaced its decision-making capacity with that of the lender. The crucial distinction between what is inequitable and what a lender can reasonably and legitimately do to protect its interests is the distinction between the existence of "control" and the exercise of that control to direct the activities of the debtor.

Smith v. Assoc. Comm. Corp. (Matter of Clark Pipe & Supply Co.), 893 F.2d 693 (5th Cir. 1990). Thus, "[u]nless 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." *Matter of Teltronics Serv., Inc.*, 29

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17 Finke, Rozen and George, *supra* note 10, C880 ALI-ABA at 341.

18 Finke, Rozen and George, *supra* note 10, C880 ALI-ABA at 341-42.

19 Finke, Rozen and George, *supra* note 10, C880 ALI-ABA at 342.

20 *Id.*

B.R. 139, 171 (Bankr. E.D.N.Y. 1983). Although a lender is not usually treated as a fiduciary of its borrower and has no duties to its borrower outside of those set forth in its loan documentation, *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357 (7th Cir. 1990), *cited with approval by Sentinel Mgmt., supra*, 728 F.3d at 669, 670, once a lender exercises such control over the debtor as amounts to control over its management or business affairs, the lender may be treated as a fiduciary.[21]

Not surprisingly, the issue of what constitutes control is fact-specific. While there is no litmus test as to which or how many factors will be considered dispositive in determining what constitutes control, among the factors that courts have been asked to review in deciding this issue are the following:

(a) the debtor's ability to disregard the advice of the lender and to act independently of the lender;

(b) whether the loan agreements between the lender and the borrower were arms'-length bargains when entered into at the inception of the relationship;

(c) whether the lender exceeded its authority under its loan agreements with the debtor;

(d) whether the lender required the borrower to hire an outside manager;

(e) whether "soft costs" assessed against the borrower's accounts were excessive;

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21 *Id.*

(f) whether the lender's scrutiny of the borrower's financial affairs blurred into dominion and control over the borrower's day-to-day management.[22]

Thus, avoiding conduct that might later be viewed as lender "control" of a borrower is an issue to be considered, and managed, at all times in a lender's relations with a borrower, most especially in workout negotiations (when the temptation to exercise control is greater). If control is established, so that the lender is a fiduciary, then the propriety of its conduct will be governed by the higher standard applicable to fiduciaries. Although control is not the *sine qua non* of equitable subordination, control is a significant factor that could "tip the scales" in favor of subordination

[22] Finke, Rozen and George, *supra* note 10, C880 ALI-ABA at 343-44 (citing *Clark Supply*, *supra*, 893 F.2d at 701); The Honorable Mary Davies Scott and Kimberley Forseth Woodard, *Lender Liability Issues and the Bankruptcy Code: Recent Developments in Fraudulent Conveyance, Equitable Subordination, Preference Actions Against Lending Institutions, and Dischargeability of Credit Card Debt*, C880 ALI-ABA 649, 658-62 (1994) (collecting cases).

Certain Critical Concepts for Avoiding Lender Liability

John A. Simon

ABI Central States Workshop
June 11-14, 2015

FOLEY
FOLEY & LARDNER LLP

Theories of Lender Liability

- Contract Claims
  - Written Agreements
    - Loan Commitments and Credit Agreements
    - Forbearance Agreements
    - Restructuring Agreements
    - Including participation agreements to participating lenders
  - Oral Agreements
    - Promissory Estoppel/Parole Evidence Rule/Statute of Frauds
    - Note - Michigan MCL 566.132
  - Implied Covenant of Good Faith and Fair Dealing
    - Prevents each party from acting in a way that deprives the other of its intended bargain
    - Subjective good faith; objective fair dealing. Prohibits dishonest conduct
    - Claims do not require breach of contract's express terms and duty does not override express provisions of the contract. Implied covenant does not undermine a party's general right to act in its own interests
    - Risk areas where discretion is exercised: MAC's, Discretionary advances, insecurity clauses, acceleration, demand notes

Theories of Lender Liability

- Common Law Claims
  - Fraud and misrepresentation
  - Breach of fiduciary duty/aiding and abetting breach of fiduciary duty
  - Deepening insolvency
  - Tortious interference with contract
  - Duress
  - “Control” theories
  - Defamation
  - Conversion/Unjust Enrichment
  - Civil Conspiracy

Theories of Lender Liability

- Statutory Claims
  - Federal Law
    - Regulatory Statutes (e.g., CERCLA, FCRA, FDCPA, TILA, RESPA, etc.)
  - State Law
    - Unfair & Deceptive Trade Practices Acts
    - Consumer protection statutes
    - State environmental statutes
    - State regulatory statutes

Theories of Lender Liability

- Bankruptcy Claims
  - Preference
  - Fraudulent transfers (new Uniform Voidable Transfers Act)
  - Automatic stay
  - Equitable subordination
  - Surcharge

Keys for Avoiding Lender Liability

- **Avoid Becoming Unduly Involved in Borrower's Business**
  - Exercise caution to avoid active participation in day-to-day business or management. Borrower must make ultimate decisions; provide options and indicate willingness to review.
    - Directing the borrower about which trade creditors should and should not be paid
    - Making representations to the borrower's trade to induce them to extend additional unsecured credit
    - Directing the borrower regarding personnel and professional hiring
    - Directing the debtor regarding business judgments that should be governed by the board or officers
    - Avoid giving advice to the debtor in regards to credit defaults.

Keys for Avoiding Lender Liability

- **Exercise Caution in Communications with Borrowers**
  - Explain the lender's position or the terms of a deal fully and carefully in writing. Avoid oral representations and promises
  - Prepare all written communications with a view that you may be asked to explain them in a deposition
  - Do not promise or threaten actions that the lender does not intend to take.
  - Whenever possible, provide the borrower with notice before taking any action that poses a significant risk of impairing the borrower's operations or financial situation. Act with no or short notice only where necessary to ensure repayment.
  - Be equally careful in communications with third-parties and courts relating to information about borrower
    - Possible or inadvertent disclosure of proprietary or confidential information about the borrower/guarantor (e.g., social security numbers contained in loan file or related documents)
  - Consider having a second individual on telephone conversations with the borrower
  - Correct the record - if the borrower sends a letter with misrepresentations or factual inaccuracies, be prompt in correcting the record
  - Silence can be viewed as acquiescence at worst and indifference at best

Keys for Avoiding Lender Liability

- **Invoke the "In-Writing Rule" & Related Defenses**
  - Use of pre-negotiation letters
  - Use relevant state laws to preclude assertions of oral agreements and modifications. See MCLA 566.132
  - Email communications may constitute a "writing" for purposes of such state laws.

Keys for Avoiding Lender Liability

- **Follow Through On Commitments and Documentation Formalities**
  - Avoid and head off if possible contractual breaches
  - If circumstances change requiring or resulting in different actions, document them accordingly.

Keys for Avoiding Lender Liability

- **Update Internal Policies and Case Memos**
  - Prepare file memos on a regular basis
  - Routinely review and update internal policies and procedures
    - Ensure that internal procedure is followed consistently
    - If the policies and procedures manual does not comport with current practice, change it
    - If circumstances demand a deviation from written policies and procedures, document the reasons for the deviation and obtain the requisite internal approvals

Keys for Avoiding Lender Liability

- **Exercise Caution with respect to Guaranty Claims**
  - Consider litigation strategy before suing on a deficiency and escalating a situation.
  - Having waived all defenses, guarantors may pursue lender liability counterclaims
    - Does the guarantor have assets worth pursuing?
    - What are the risks of lender liability

Keys for Avoiding Lender Liability

- **Work with Your Counsel Early to Vet any Actions or Issues of Concern**

Death by Tiny Cuts – The Ways Lenders Lose

For

Critical Concepts for Avoiding Lender Liability
(What All Lenders Should Know)
American Bankruptcy Institute Central States Bankruptcy Workshop
Traverse City, MI
June 11 – 14, 2015

Submitted by
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April 24, 2015

US_ACTIVE-121436052.1-ATERRAS 05/03/2015 11:31 AM

A lender will be liable to a borrower for breach of contract, fraud and business torts, but the only good counsel a lawyer can give a lender client to avoid these straightforward claims is "don't do that". Absent the obvious, the lender's relationship with the borrower is non-fiduciary, *see e.g. Marine Midland Bank v. Yoruk*, 242 A.D. 2d 932 (N.Y.S. 1997) and contractual. The contract by its terms universally favors and protects the lender and excludes, by its terms and/or statute, *see e.g.* the Illinois Credit Agreement Act, 815 ILCS 160, parol evidence to vary its terms.

The integrity of the lender's thick skin often breaks down into protracted litigation and actual liability as a result of tiny cuts and these are mostly self-inflicted. Below is a list of the most common.

1. <u>Stupidity that shocks the conscience (and the jury).</u>

Mr. Weiner: Where were you when Mr. Smith called you?

Ms. Jones: In my cubicle.

Mr. Weiner: Did you know who Mr. Smith was?

Ms. Jones: He was my boss' boss' boss although I had never met him in person.

Mr. Weiner: What did he ask you?

Ms. Jones: He said "I understand that you follow ABC Widgets Co. for the bank, how are they doing?"

Mr. Weiner: What did you say?

Ms. Jones: I said "yes, sir. They're experiencing some unexpected weakness in their core markets."

Mr. Weiner: Did Mr. Smith say anything else?

Ms. Jones: He said, "Good, my customer told me over lunch that he had gone short on 10 million shares of ABC Widget."

Mr. Weiner: When Mr. Smith said that did you know how many shares of ABC Widget were outstanding?

Ms. Jones: Yes, I know that for all the companies I track as an analyst. It was 5 million for ABC Widget.

Mr. Weiner: Did you tell Mr. Smith that?

Ms. Jones: No, I didn't think it was my place.

And when Mr. Smith's customer turned out to be Mr. Madoff re-incarnated, a Ponzi investor could allege just enough "actual knowledge" to sustain a cause of action and open a Pandora's box of discovery and difficulty for the bank. *See, e.g. Wiand et al. v. Wells Fargo Bank N.A., et al.,* No. 12-0557, 938F. Supp.2d 1238, 1244 (M.D. Fla. 2013); compare *Coquina Investments v. Rothstein & TD Bank, N.A.*, No. 10-60786, 2012 WL 4479057 (S.D. Fla. Sept. 28, 2012), *aff'd*, No. 12-11161, 2014 WL 3720301 (11th Cir. July 29, 2014).

Remedy: You can't fix stupid, but failures to communicate, especially through hierarchical barriers, can later appear to be so beyond stupid as to mandate the alternate conclusion of complicity, aiding and abetting. Open communication within the organization is essential.

2. Cupidity that shocks the conscience.

The lender's yield on lease financing of System X is prime plus eleven. System X volume has put the leasing unit over the top on its volume targets in the past two quarters. The GM of the lease finance business is told that there are multiple operational issues with System X and, in fact, it may not work at all. The GC of the lease business tells him that the "hell or high water clauses in the lease are enforceable – absolutely." The GM sends out an e-mail "future System X volume will be restricted to lessees with top tier credit and we will no longer take residual risk since end of lease value of System X may be negligible." *See, e.g. IFC Credit Corporation v. Speciality Optical Systems, Inc*., 252 S.W.3d 761 (Tex. Ct. App. 2008); and *FTC v. IFC Credit Corp.*, No. 07-C-3155, 543 F.Supp.2d 925 (N.D. Ill 2008).

Remedy: Senior executives need to see the big picture (or rather the big perception of judge or jury). Legal interpretations which arguably trample on the mores of the marketplace will be subject to stricter scrutiny in the presence of evidence that the lender's decisions were driven only by the bottom line.

3. Constructive attribution of institutional knowledge.

A large organization has many departments which are necessarily compartmentalized by function, location or other corporate need. The banker doing the deal sometimes does not know what the bank knows, but, if he knew it, failure to disclosure would be an omission to state a material fact.

Example: an internal auditor expresses concern with the integrity of a borrower's financial statements. This information reaches the work out officer, but it does not reach the banker eager to finance a competitor's acquisition of all or a part of the borrower's business. *See e.g. Champion Intern. Corp. v. First Nat. Bank of Jackson*, 642 F.Supp. 237 (S.D. Miss. 1986).

Remedy: Systems and policy must permit and require front end bankers to review what the bank knows about deal participants.

4. <u>Guilt by irregularity.</u>

The borrower alleges that the lender's calling officer misled him. The judge is about to invoke the parol evidence rule, exclude this evidence and enter judgment for the bank. At his deposition, the calling officer admits that the borrower, a contractor, remodeled his kitchen for less than half what all the other bidders proposed.

This "irregularity": (i) has no effect on the applicability of the parol evidence rule; (ii) diminishes the credibility of the borrower; but (iii) also diminishes the credibility of the calling officer. In the presence of precedent such as *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit*, 55 Cal. 4th 1169, 151 Cal. Rptr.3d 93, 291 P.3d 316 (2013). the judge, now intrigued, denies summary judgment. The bank settles. *See, e.g. American Bank Center v. Wiest*, 2010 ND 251, 793 N.W. 2d 172 (N.D. 2010).

<u>Remedy:</u> Bad acts by bank officers sully the bank, even if the bank is the victim. Beyond corporate ethics and compliance, counsel needs to interview the bank's own witnesses and know what discoverable personnel records may show.

5. <u>Don't make loans you can't book.</u>

The bank enters into a complex fixed payment variable rate arrangement with borrower which resets prospectively both monthly (as to rate) and annually (as to fixed payment). The bank fails to enter the contractual loan terms into its invoicing program, and as a result, the invoices reset both rate and payment monthly. Because interest rates decline, the customer in paying the erroneous invoices, amortizes the loan more slowly than contractually required.

Post-closing errors are often not entitled to the protections of merger/integration clauses or the parol evidence rule and create detrimental reliance claims and defenses. A court rejects the bank's belated attempts to force a "catch up" payment. As a result the entire loan needs to be reserved since the loan to value progression is now out of whack.

Remedy: Don't make loans the bank's systems can't easily administer or which require individual, as opposed to institutional, historical background. If errors are made, confess and correct them immediately. Unilateral knowledge of honest mistakes becomes bad faith if long concealed. The cover up is worse than the crime.

6. Appearances of impropriety.

One of the banks lesser outside counsel firms asks the bank to waive a conflict in order to permit the firm to represent an individual client in a collection lawsuit brought by the bank. The bank's in house lawyer says in jest "Ok, I'll grant the waiver, but don't hurt us too bad." Inexplicably, the outside lawyer repeats the remark to his other client and still agrees to accept the other engagement to preserve his firm's more lucrative engagement by the same client as her divorce counsel. The bank obtains judgment in the collection case, the divorce settlement doesn't work out well and now the judgment debtor can't pay. Her new lawyer sues his old lawyer and the bank for a conspiracy to provide her with a less than adequate defense in the bank's collection lawsuit.

Obvious conflicts of interest aside (such as providing a customer's confidential financial information to another customer who is a competitor), appearances of impropriety can arise indirectly in the course of a lender's normal relationships with other banks, loan participants, accountants, turnaround professionals and lawyers.

Remedy: The lender must itself be vigilant, and require its professionals, to be vigilant to guard against conflicts of interest, whether real or apparent. The mere existence of a conflict is sometimes *res ipsa loquitur* as to the cause of a bad outcome even if the bad outcome is completely unrelated to the conflict.

LENDER LIABILITY -- EASY TO CLAIM, NOT SO EASY TO DISCOVER (PSST – LOOK OVER HERE……)

For

Critical Concepts for Avoiding Lender Liability
(What All Lenders Should Know)
American Bankruptcy Institute Central States Bankruptcy Workshop
Traverse City, MI
June 11 – 14, 2015

Submitted by
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April 24, 2015

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DISCOVERY

In bringing a claim or asserting a defense based on lender liability, a debtor is permitted to discover any matter relevant to the claim that is not privileged. See Fed.R.Civ.P. 26(b)(1).[1] "Relevant information need not be admissible at the trial if the discovery appears reasonably calculated to lead to the discovery of admissible evidence." Rule 26(b)(1)[2]; see generally Fed.R.Ev. 401 and 402 (providing that evidence is generally admissible if it tends to prove or disprove a matter at issue in the case).[3] A debtor must nevertheless keep in mind that "every discovery request, response, or objection should be grounded on a theory that is reasonable under the precedents or a good faith belief as to what should be the law." Advisory Committee Notes, 1983 Amendments, Rule 26(g).[4]

I. Lender Liability Substantiated Through Discovery

Awareness of a bank's complicated *modus operandi* is the key to knowing what to ask and where to look for discoverable matter to support a lender liability claim.

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[1] See also *MCR* 2.302(B)(1).
[2] See also MCR 2.302(B)(1).
[3] See also MRE 401 and 402.
[4] See also Fera v. Plaza, Inc., 218 N.W.2d 155, 158 (Mich. Ct. App. 1974) (inferring same under Michigan law), rev'd on other grounds, 242 N.W.2d 372 (Mich. 1976).

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A. Regulatory Compliance

Banks must navigate a labyrinth of oversight and regulations.

1. Regulators

A bank receives oversight from a number of governmental entities, including the Office of the Comptroller of the Currency for national banks; the Board of Governors of the Federal Reserve System for state-chartered banks that belong to the Federal Reserve System; and the Federal Deposit Insurance Corporation for state-chartered banks that do not belong to the Federal Reserve System.[5] "Although the rules, regulations, and approaches of the various agencies differ, the basic approach is relatively uniform. Regulators assess the safety and soundness through annual examinations of bank assets and operations." M. Todd Henderson and Frederick Tung, Pay for Regulator Performance, 85 S. Cal. L. R. 1003, 1016 (May 2012).

2. Law

Regulators enforce a seemingly endless number of federal and state regulatory laws, such as the Federal Deposit Insurance Act ("FDIA").[6] The FDIA requires

> every national bank, state member bank, and insured state nonmember bank . . . to file Consolidated Reports of Condition and Income (also known as the Call Report) . . . . All assets and liabilities, including contingent assets and liabilities, must be reported in, or otherwise taken into account in the preparation of, the Call Report. The FDIC uses Call Report data to . . . monitor the condition, performance, and risk profile of individual banks and the banking industry.

[5] www.sec.gov/answers/bankreg.htm; see also www.michigan.gov/difs/0,5269,7-303-13047_32588---,00.html (showing that oversight comes also from state regulators, such as Michigan's Department of Insurance and Financial Services).
[6] Cf. Michael v. FDIC, 687 F.3d 337, 342 (7th Cir. 2012) (indicating that governing law includes state law).

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12 C.F.R. § 304.3(a) (2015). Another example of regulatory law is the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") (codified throughout Title 12 of the United States Code), "requir[ing] annual safety-and-soundness examinations for all insured institutions." Christopher M. Straw, Unnecessary Risk: How the FDIC's Examination Policies Threaten the Security of the Bank Insurance Fund, 10 N.Y.U. J. Legis. & Pub. Pol'y 395, 405 (2006/2007) (citing 12 U.S.C. § 1820(d)).

3. Ratings

The information generated in regulators' reports and examinations is used in rating the financial and operational health of a bank. One rating system is FDICIA categorization provided under 12 U.S.C. § 1831(o)(b)(1)(A)-(E), which analyzes and labels a bank as either "Well Capitalized," "Adequately Capitalized," "Undercapitalized," "Significantly Undercapitalized," and "Critically Undercapitalized." See Grant Thornton, LLC v. Office of Comptroller, 514 F.3d 1328, 1338-39 (D.C. Cir. 2008) (showing Call Reports contributing to FDICIA categorization). Another rating system is a five-point scale (with one being the highest rating), which assesses certain aspects of a bank as represented in the acronym, "CAMELS" (C for capital; A for asset quality; M for management; E for earnings; L for liquidity; and S for sensitivity to market risk). See United W. Bank v. Office of the Comptroller of the Currency, 928 F. Supp. 2d 70, 74 (D.D.C. 2013) (showing examinations contributing to CAMELS ratings). Comments and recommendations for improvements often accompany ratings. See Sarah Peiwoo, Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales, 99 Geo. L.J. 1615, 1627 n.43 (August 2011).

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4. Implications of poor ratings

Poor ratings can lead to increased periodic examinations and reporting, memoranda of understanding, consent orders, corrective action letters, and cease and desist letters. See, e.g., In re Colonial BancGroup, Inc., 436 B.R. 713, 730-31 (Bankr. M.D. Ala. 2010) (showing this effect).

5. Relevance

Any matter resulting from regulatory compliance could be useful in substantiating lender liability claims.

B. Independent Review

In addition, a bank and its directors also owe a duty to the bank's stakeholders to identify and monitor troubled loans, and to commission an independent review to determine weaknesses in the bank's overall loan portfolio. See, e.g., FDIC v. Saphir, 2011 U.S. Dist. LEXIS 98560, at *10, *20 (N.D. Ill. 2011); Collins v. SunTrust, Inc., 2006 U.S. Dist. LEXIS 28813, at *3 (M.D. Tenn. 2006)). A bank can seek a consultant's independent input in other contexts too, such as in advance of a regulator's examination. Any of this information could also be useful to a debtor in asserting lender liability claims.

II. No Special Types of Regulatory Disclosure Prohibitions

None of the foregoing information appears to be subject to any special types of regulatory disclosure prohibitions. See, e.g., 12 C.F.R. § 19.24 (2015) ("Scope of document discovery") (regards the Office of the Comptroller of the Currency and is in line with discovery standard provided above); 12 C.F.R. § 263.24 (2015) ("Scope of document discovery") (regards the Board of Governors of the Federal Reserve System and is in line with discovery standard provided above); and 12 C.F.R. § 308.24 (2015) ("Scope of document discovery") (regards the Federal Deposit Insurance Corporation and is in line with discovery standard provided above).

LENDERS' FILES – A POTENTIAL TREASURE TROVE FOR BORROWERS

A. Introduction

Debtors asserting lender liability claims, can seek discovery of internal bank documents designed to support their allegations. Internal communications, reports, audits and other memoranda ("Internal Documents") may be discoverable to debtors claiming lender liability based on fraud, misrepresentation or other colorable claims. Notwithstanding debtors' efforts to discover Internal Documents, lenders can take steps designed to help insulate specific transactions – and perhaps their broader portfolio – from damaging attacks.

Access to Internal Documents through discovery can rupture a lender's Achilles heel. Lenders who represent one course of action to their customers inconsistent with a different course of action with its regulators can face setoffs or liability over and above the loan indebtedness. Consistent positions – externally to customers and internally to its file (or to regulators) - - effectively avoids lender liability exposure in this area. Notwithstanding the discoverability of Internal Documents, lenders can avert many lender liability claims by memorializing their external actions consistently with their internal actions.

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The following two cases expose the danger of lenders who chose to paint one picture to their customer, but paint a much different picture behind the scenes – *and who then memorialize their behind the scenes paintings*. These painting should match. Even if debtors dislike lenders' decisions to exit a credit, lenders can avert claims for misrepresentation or fraud by acting internally consistent with their external representations, and by memorializing those representations accordingly.

B. Case Law Examples of Lender Liability by Taking Inconsistent Positions

1. *Richter, S.A. v. Bank of America Nat'l Trust & Sav. Ass'n*, 939 F.2d 1176 (5th Cir. Tex. 1991)

The Fifth Circuit Court of Appeals affirmed a $1,155,500 award in favor of a plaintiff against a bank for negligent misrepresentation. In *Richter*, the bank experienced financial losses, planned to reduce its customer base and adopted a classification scheme for existing customers.[7] At same time, the company was trying to restructure its financing with the bank. On multiple occasions over several months, the bank continued to represent that it was interested in negotiating with the company and that it "wanted to do a deal," despite, and unbeknownst to the company, having already decided to "disengage."[8] The bank then downgraded the company four times within eight months. During the case, one of the bank officials testified that customers are not informed about the downgrading of their credit.[9]

[7] *Richter*, 939 F.2d 1176, 1182.
[8] *Richter*, 939 F.2d 1176, 1182.
[9] *Richter*, 939 F.2d 1176, 1182.

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Each time the bank internally downgraded the company, the bank attached an internal memo discussing the bank's desire to "disengage as quickly as possible" and that it did not want to "keep this relationship."[10] These internal memos were starkly different than the external representations made by the bank to the company, and to the Plaintiff funding the company's operations while relying on the bank's external representations that it would help to restructure the company's finances. The bank's internal documents reflected its plan to terminate the credit, notwithstanding its simultaneous expression of optimism to reach a financing arrangement with the company.

The bank's ultimate liability for negligent representation and failure to negotiate in good faith were evidenced by the bank's own Internal Documents – a classic case of self-inflicted injury. Had the bank represented its true intentions to the company, the bank could have averted these lender liability claims.

2. *NCNB Tex. Nat'l Bank v. Perry Bros.*, 1999 U.S. App. LEXIS 40246 (5th Cir. Tex. June 17, 1999)

The *NCNB* court affirmed a post remand judgment in favor of borrower against the bank for fraud, execution of loan under duress and for business disparagement. In *NCNB*, Perry Brothers' original lender was declared insolvent, a receiver was appointed and NationsBank was required to purchase all of the original lender's loans and minimize financial assistance from the FDIC.[11] Under its contract with the FDIC, NationsBank was incentivized to modify the terms of

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[10] *Richter*, 939 F.2d 1176, 1182.
[11] *NCNB*, 1999 U.S. App. LEXIS 40246, *2.

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certain loans because NationsBank could transfer back to the FDIC loans assumed before a certain date only if NationsBank sufficiently altered the terms at renewal.[12]

When Perry Brothers' original lender was declared insolvent, Perry Brothers was in the midst of restructuring its loan, and was now required to begin working with NationsBank. An internal NationsBank "Scheduled Asset Report" reclassified Perry Brothers as a "decrease" debtor and reclassified the loan as a "watch" credit. The following month, after violating net worth covenants, Perry Brothers asked a senior-vice president about NationsBank's comfort level with the loan, and NationsBank affirmatively discouraged Perry Brothers from seeking or investigating alternative credit.[13] In fact, NationsBank memorialized discouraging Perry Brothers from alternative financing in another internal memo.[14]

Despite NationsBank's urging for Perry Brothers not to seek new money elsewhere, NationsBank management at the same time rejected recommendations to renew the loan on the same terms as the previous loan with its original lender. The Credit Review Committee reclassified Perry Brothers' loan as "substandard" – a drop that triggered "vulnerable borrower" status under the NationsBank/FDIC contract - - which Perry Brothers would be required to report to prospective lenders. Perry Brothers attempted, but failed, to obtain any alternative credit.[15]

NationsBank subsequently gave Perry Brothers a "special asset" designation and despite an oral non-setoff agreement, proceeded to setoff over $1.3 million from Perry Brothers' accounts

[12] *NCNB*, 1999 U.S. App. LEXIS 40246, *3.
[13] *NCNB*, 1999 U.S. App. LEXIS 40246, *3-4.
[14] *NCNB*, 1999 U.S. App. LEXIS 40246, *4.
[15] *NCNB*, 1999 U.S. App. LEXIS 40246, *4-6.

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with NationsBank, blocked access to its other accounts, and returned over $130,000 in checks for insufficient funds just before the holiday season. NationsBank's internal documents showed that it was aware of Perry Brothers' capital improvement plans, that Perry Brothers needed cash, and knew how disastrous a setoff would be just before the holiday season.

The *NCNB* Court held, among other things, that NationsBank was culpable for not correcting the known material misunderstanding caused by officials and that the improper reclassification of the Perry Brothers' loan as "substandard" was an ongoing wrongful act.

C. Averting Lender Liability Claims

Lenders' Internal Documents share the same underlying characteristics – they help lenders (i) adhere to policies, (ii) assess their individual loans and overall portfolio, (iii) assess collectability, and (iv) identify borrowers' weaknesses.

Many of those Internal Documents are the first place debtors can look when pursuing lender liability claims, and may include:

- Classification Schemes (where each customer account is graded or classified);
- Internal memoranda or reports discussing the classification of customer accounts;
- Internal memoranda or reports discussing a change in classification of customer accounts;

- Internal memoranda or reports summarizing communications or representations to customers;
- Reports identifying compliance by customers with lender policies;
- Reports or negotiations regarding letters of intent or agreements to lend money;
- Independent review reports or audits;
- Reports or audits provided to federal and/or state auditors;
- Audit reports created internally or provided by third party professionals; and
- Reports from consultants performing regulatory compliance activities.

PRE-NEGOTIATION AGREEMENTS – SWORDS OR SHIELDS?

For

Critical Concepts for Avoiding Lender Liability
(What All Lenders Should Know)
American Bankruptcy Institute Central States Bankruptcy Workshop
Traverse City, MI
June 11 – 14, 2015

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April 24, 2015

Pre-Negotiation Agreements ("PNA") are invaluable tools for lenders facing negotiations with borrowers in default. PNAs set the tone of, and expectations for, negotiations between these parties – before the negotiations even begin – and help preserve the lenders' rights under their loan documents. Lenders may open themselves to liability in the first instance by responding to a borrower's requested forbearance by sending the borrower a non-binding letter of intent or term sheet, instead of leading off with a PNA. Not only are PNAs useful for "looking ahead" (e.g., setting the rules of the non-binding status of negotiations) but also for "looking behind" by requiring borrowers to ratify their original transaction(s).

PNAs should be used as a shield to protect the lender, but are sometimes used as a sword to require the borrower to give up rights or waive defenses. Regardless of the lender's philosophy, here are two guiding principles:

1. K.I.S.S. – Keep it Simple Stupid

The central purpose of the PNA is not to negotiate the deal, but simply to set the ground rules for those negotiations. Protracted discussions over the PNA will likely undermine its purpose, expend unnecessary time and energy and distract the parties' attention from the main event – the upcoming negotiations themselves. More importantly, the more the lender wants to use the PNA as a sword, the less likely the borrower will be willing to sign it.

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2. Fair Means Fair

Lenders should resist the temptation to try to better their position under the guise of a PNA. Lenders that use the PNA as a sword to better their position, rather than as a shield to protect themselves, may appear disingenuous and damage their bona fides with the borrower. An aggressive borrower may try to demonstrate at trial a lender's bad faith in using evidence of PNA negotiations to gain "a leg up" should negotiations fail. Better for the lender to better its position directly through a loan amendment or forbearance agreement than indirectly through a PNA.

Now, let's look at some specific provisions.

"Looking Ahead" - Setting Borrower's Expectations

Before a lender and borrower can engage in negotiations, the lender should set the borrower's expectations. A lender should use the PNA to tell the borrower that lender is not obligated, but is rather choosing, to negotiate with borrower. Doing so may encourage borrower to negotiate a bit more seriously, knowing that a breakdown in lender's voluntary decision to negotiate may lead to the swift exercise of its remedies under the loan documents.

1. <u>Negotiations May Terminate at Any Time</u>

Either party, in its sole and absolute discretion, may terminate negotiations for any reason at any time. Although this may create a “thin-ice” environment, the fragile nature of these negotiations can help facilitate serious discussions by the borrower (and the lender).

2. Settlement Discussions under the PNA are Confidential and <u>Inadmissible and Survive Termination of the PNA</u>

All negotiations, discussions, draft documents, loan modification proposals or other representations should be treated as confidential and inadmissible. Protecting the parties' confidences during negotiations engenders open and honest discussions and allows each party to honestly discuss their positions. The confidentiality and inadmissibility provisions should survive the termination of the PNA.

3. No Agreement Is Binding Until Lender and Borrower Execute a <u>Definitive Written Agreement</u>

Unless and until the lender and borrower execute a final agreement, each party can take comfort knowing that any oral or written discussions, representations, draft documents or emails cannot be used against the other party as evidence of a binding agreement. This requirement may help the parties pursue their negotiations through the execution of definitive documentation.

4. <u>No Wavier of Rights and Remedies / Enforcement of Remedies</u>

Similar to the confidentiality and inadmissibility provisions, anti-waiver paragraphs also allow the parties to negotiate freely without worry that any oral or written statements or representations could waive their respective rights or remedies. In addition, this paragraph helps preserve the status quo regarding the lender's remedies under the loan documents and the lender's ability to enforce those remedies at any time.

5. <u>Term</u>

Setting a specific term for negotiations, along with an expiration date for the PNA, incentivizes a borrower to seriously negotiate since the lender may choose not to extend the PNA and move to enforce its remedies.

"Looking Behind" – Requiring Borrower to Ratify the Loan Transaction (and How Much More?)

A lender should set the tone for negotiations by requiring a borrower not only to acknowledge its existing defaults, but also to ratify the loan documents. Ratifying the loan documents may help to prevent any subsequent challenge that the borrower (i) lacked actual or apparent authority to enter into the loan transaction, or (ii) disputes the validity of, or obligations under, the loan. Ratification of a loan also will likely act as an implied adoption, recognition and approval of unauthorized acts of another.[1]

"Ratification in agency is an adoption or confirmation by one person of an act performed on his behalf by another...one who accepts the benefits of the unauthorized acts of his agent ratifies those acts and accepts all the burdens and benefits of those acts."[2]

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[1] *See Vargas Realty Enters. v. CFA W. 111 St., L.L.C.* (*In re Vargas Realty Enters*.), 440 B.R. 224, 235 (S.D.N.Y. 2010) (*quoting Orix Credit Alliance v. Phillips-Mahnen, Inc.,* No. 89 Civ. 8376 (THK), 1993 U.S. Dist. LEXIS 7071, 1993 WL 183766, at *4 (S.D.N.Y. May 26, 1993)) (court held that appellant's "failure to object after learning of the [loan transaction] and their subsequent entry into an agreement confirming their obligations under the [loan transaction] served as proper ratification of the underlying loan transaction.")

[2] *Warner v. Federal Deposit Ins. Corp.*, 672 F. Supp. 1028 (S.D. Ohio 1987) (internal citations omitted).

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Specifically, a lender could require a borrower to acknowledge that the borrower's signatory had authority to execute the loan documents, that the loan documents were in fact validly executed, that security interests were validly given to, and perfected by, lender, and that all loan documents have been, and remain, in full force and effect. Sometimes this transforms the shield into a sword. Ratification of the underlying loan transaction likely renders the loan documents valid and enforceable, despite any subsequent challenges to the contrary by the borrower.

A lender should require the PNA to be executed by multiple representatives where possible and should also require execution by all corporate and individual guarantors.

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