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What Lawyers and FAs Must Know to Successfully Represent Secured Creditors

Eric W. Anderson, Moderator
Parker, Hudson, Rainer & Dobbs LLP; Atlanta

Leyza F. Blanco
GrayRobinson, P.A.; Miami

Douglas M. Foley
McGuireWoods LLP; Washington, D.C.

Ryan A. Maupin
Grant Thornton LLP; New York

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Anticipating Lender Liability Claims—Predicting Punches[1]

"An ounce of prevention is worth a pound of cure."
—Benjamin Franklin

Douglas M. Foley
Partner, McGuireWoods LLP (Washington D.C.)[2]

The 2007 financial crisis has led to a proliferation of "lender-liability" suits as cash-strapped debtors and out of the money constituents seek deep pockets from which to recover funds. Whether it be defending lawsuits based on malfeasance or nonfeasance or defending the validity, extent, and priority of its liens, lenders are subject to attack at almost any juncture and from all sides. Even with the end of the financial crisis, this trend continues as retail giants fall and debtors turn to quick 363 sales with increasing frequency. In light of this distressed landscape, lenders should pay particular attention to potential pitfalls as they approach distressed borrower relationships.

The typical claims raised by borrowers include one or a combination of the following: a breach of the covenant of good faith and fair dealing or a breach of fiduciary duty arising from a "special relationship" between the borrower and the lender and/or the lender's control of the borrower's operations.[3] A borrower may affirmatively assert lender liability claims as a plaintiff or assert them as counterclaims as a defendant in a lender-initiated foreclosure action or lawsuit.[4] In bankruptcy, lenders face additional causes of action derived from the Bankruptcy Code itself or claims resulting from the Bankruptcy Court's equitable jurisdiction. This article focuses on several of the most common bases of lender liability in distressed financial situations and is designed to provide a quick reference guide to help frame distressed loan strategies.

Covenant of Good Faith and Fair Dealing

Because "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement,"[5] lenders are likely to face allegations of breaches of these covenants in the context of a lender liability suit. Broadly speaking, the covenant of good faith and fair dealing requires a party to a contract to deal with the other honestly, fairly, and in good

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[2] I gratefully acknowledge the research support provided by Anna Haugen and Kathryn Z. Keane in preparing this article.

[3] Michelle Z. McDonald, *The Complicated World of Lender Liability*, 40-APR COLO. LAW 13, 14 (Apr. 2011).

[4] *Id*.

[5] Restatement (Second) of Contracts § 205 (1981).

faith, so as not to deprive the other party of the benefits of their contract.[6] The Uniform Commercial Code, which can govern lending relationships in the context of sales transactions, secured transactions, promissory notes, and negotiable instruments, defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[7] The covenant of good faith and fair dealing applies when the performance of a specific contract term permits either party to exercise discretion.[8] When a contract is silent, the principles of good faith fill the gap.

Nevertheless, the covenant of good faith and fair dealing cannot be applied in a manner that contradicts the express terms or conditions of a contract.[9] Allegations of bad faith frequently focus upon lender action taken shortly before or after a default under the loan documents or a failed attempt to refinance or restructure the loan. Generally, a lender does not have an obligation to assist a borrower in restructuring an existing loan unless there is an express provision in the loan documents to the contrary.[10] Accordingly, a mere failure to assist in refinancing is not sufficient. But, lender liability issues may arise when the loan documents give the lender approval or consent

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[6] Comment d to § 205 states as follows:

> Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

[7] U.C.C. § 1-201(b)(20) (amended 2003). *See, e.g.*, *Precision Pine & Timber, Inc. v. United States*, 596 F.3d 817, 820 n.1 (Fed. Cir. 2010) ("Both the duty not to hinder and the duty to cooperate are aspects of the implied duty of good faith and fair dealing."). *Essex Electro Eng'rs, Inc. v. Danzig*, 224 F.3d 1283, 1291 (Fed. Cir. 2000) ("Every contract, as an aspect of the duty of good faith and fair dealing, imposes an implied obligation 'that neither party will do anything that will hinder or delay the other party in performance of the contract.'").

[8] McDonald, 40-APR COLO. LAW at 14.

[9] *See Metcalf Constr. Co. v. United States*, 742 F.3d 984, 991 (Fed. Cir. 2014) ("The implied duty of good faith and fair dealing is limited by the original bargain: it prevents a party's acts or omissions that, though not proscribed by the contract expressly, are inconsistent with the contract's purpose and deprive the other party of the contemplated value."); *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188, 1195 (10th Cir. 2004) ("The implied covenant cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract.) (internal quotation marks omitted). A lender generally does not breach the covenant of good faith and fair dealing unless its conduct is dishonest, intentionally deceptive, or constitutes an outrageous behavior. *Mora v. US Bank*, No. cv-15-2436, 2015 WL 4537218, at *4 (C.D. Cal. July 27, 2015) (dismissing claim for breach of the implied covenant of good faith and fair dealing where plaintiffs had "not alleged that they fulfilled their obligations under the mortgage loan contract," alleging instead that they could not make scheduled payments, declared bankruptcy to avoid foreclosure, and further stopped performing when "it was clear that they were excused from further performance by acts of discrimination against them").

[10] Indeed, acting consistent with its rights under a loan agreement is generally insufficient to support a finding that a lender breached the implied covenant of good faith and fair dealing. *See Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings, Inc.)*, 541 B.R. 551, 568–70 (S.D.N.Y. 2015) ("Put simply, a party does not breach an agreement by behaving as the instrument permitted.").

rights over borrower's actions.[11] To protect from later attacks on its business judgment, a lender's actions should be based on well-documented and commercially reasonable grounds.[12]

In light of increasing scrutiny from creditor and other groups, lenders should also take precautionary steps when approaching a distressed lending relationship. While every situation presents its own unique challenges, precautionary steps may include, but not be limited to, the following: 1) providing the borrower with reasonable written notice before taking material actions even if written notice is not required by the loan documents; 2) providing the borrower with an opportunity to cure nonmonetary defaults before pursuing any remedies; 3) considering reasonable proposals made by a borrower while negotiating a restructuring or modification of the loan and responding to such proposals within a reasonable time; 4) promptly addressing borrower requests and documenting lender responses, whatever that response may be; 5) demonstrating adequate consideration for other aspects of the loan, such as reviewing borrower's appraisals or independently analyzing the value of the collateral; 6) avoiding the exercise of harsh remedies for technical, nonmonetary defaults; and 7) expediently commencing a foreclosure following a default.[13] Initial communications should clearly state that the lender is not waiving any right or remedy by delaying immediate enforcement of its contractual rights (such as enforcing default interest, sweeping accounts, or foreclosing). Importantly, a lender should reinforce that no discussions are final or binding until they are in writing and signed by both parties.

Further, as part of any forbearance or workout agreement, a lender should obtain a general release from its borrower of known and unknown claims through the date of execution. Workout or forbearance agreements also present good opportunities to fix any defects in the original loan documentation—tighten liquidity requirements, obtain additional collateral, strengthen remedies upon default, provide for more frequent reporting, *etc*. Lenders should weigh the need for a release against the costs of potential borrower concessions. Legal and financial advisors can help determine and evaluate the impact of monetary and non-monetary concessions.

If a workout is not feasible, lenders should avoid any unreasonable delay in responding to borrower inquiries or proposals so as to avoid an impression that the loan could be restructured or that a borrower's proposal is being carefully considered. Moreover, taking extreme measures on technical defaults, especially on commercial loans, such as a failure to timely submit financial statements, are generally not received well by courts. Lastly, lenders should be wary of quickly altering their course of conduct with their borrowers unless warranted by the circumstances.[14] For

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[11] *See, e.g.*, *K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 759–60 (6th Cir. 1985).

[12] Business judgment also serves as a powerful defense to a later lawsuit.

[13] *Compare K.M.C. Co., Inc.*, 757 F.2d at 759–60 (awarding $7.5 million to a borrower when a lender breached a covenant of good faith by failing to give sufficient notice before refusing to advance funds up to the maximum limit of a revolving line of credit) *with Westinghouse Elec. Corp. v. McLean*, 938 F. Supp. 487, 494 (N.D. Ill. 1996) (finding lender not liable for failing to disburse additional funds to borrower because the credit agreement provided that disbursements of funds by lender would be discretionary).

[14] *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 calling of a loan was made in good faith where, among other things, bank had "clear knowledge that [the borrower] had on hand in the Bank, and tendered, funds sufficient to satisfy the interest requirement; the Bank

instance, after an established pattern of ignoring defaults, a letter or communication demanding strict compliance with the terms of a loan document (especially non-material provisions) without providing, at a minimum, prior written notice or a very brief cure period may trigger liability.[15] At the end of the day, a lender should approach a distressed situation as it would any business relationship: with careful consideration of the pros and cons and clear and effective communication, keeping in mind the principles discussed herein.

Breach of Fiduciary Duties

Courts are reluctant to convert the lending relationship into a fiduciary one absent special circumstances.[16] Thus, generally a lender's duties to its borrower are delineated in the loan agreement and accompanying documents. However, when a lender possesses too much control over the borrower or the borrower relies on the lender's trust and confidence as a result of special circumstances, the borrower-lender relationship may be converted into a fiduciary one.[17] In those cases, the lender will owe the borrower duties greater than those set forth in the loan documents.

Certain actions, however, are normal course between a borrower and lender and will not result in the imposition of a fiduciary relationship. For example, in *FAMM Steel, Inc. v. Sovereign Bank*,[18] an institutional bank loaned money to a borrower to expand its steel fabrication operations. Due to unexpected circumstances, the borrower suffered operating losses resulting in financial difficulties, which ultimately led to default.[19] After the borrower defaulted, the lender requested that the borrower hire an outside turnaround consultant approved by the lender to monitor its

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had previously accepted late payments in its course of dealings with [the borrower]; 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").

[15] *See, e.g.*, *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 a lender where the lender routinely waived technical defaults, but demanded full payment one month before the due date), *aff'd*, 989 F.2d 490 (3d Cir. 1993).

[16] *Sallee v. Fort Knox Nat'l Bank, N.A. (In re Sallee)*, 286 F.3d 878, 893 (6th Cir. 2002) ("Except in special circumstances, a bank does not have a fiduciary relationship with its borrowers."); *Forsythe v. BancBoston Mortg. Corp.*, 135 F.3d 1069, 1077 (6th Cir. 1997) ("[T]he great weight of authority is that while the relationship between a mortgagor and mortgagee is often described as one of trust, technically it is not of a fiduciary character.") (alterations in original and internal quotation marks omitted). Indeed, as noted by the Third Circuit Court of Appeals, it "'would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table.'" *Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 53 (3d Cir. 1988) (quoting *Weinberger v. Kendrick*, 698 F.2d 61, 79 (2d Cir. 1982), *cert denied*, 464 U.S. 818)); *see also Needham v. The Provident Bank*, 675 N.E.2d 514, 522 (finding no fiduciary relationship based on bank's advertisement as a "Partner in Business").

[17] *Compare Steelvest, Inc. v. Scansteel Serv. Ctr., Inc.*, 807 S.W.2d 476, 485 (Ky. 1991) (imposing fiduciary duty where bank used borrower's confidential information to assist one of borrower's competitors to generate new business for bank); *Broomfield v. Kosow*, 349 Mass. 749, 212 N.E.2d 556, 560 (Mass. 1965) ("[T]he plaintiff alone, by reposing trust and confidence in the defendant, cannot thereby transform a business relationship into one which is fiduciary in nature. The catalyst in such a change is the defendant's knowledge of the plaintiff's reliance upon him.") *with Cowan Bros. v. Am. State Bank*, 743 N.W.2d 411, 420–22 (S.D. 2007) (finding bank did not owe borrower a fiduciary duty when it allegedly engaged in malicious and oppressive conduct).

[18] 571 F.3d 93 (1st Cir. 2009).

[19] *Id.* at 97.

operations, terminated automatic bank sweeps between the borrower's checking account and its line of credit without notifying the borrower, and failed to respond to various workout or refinancing proposals.[20] As a result, the borrower terminated operations, which resulted in a loss of more than $4 million.[21] The borrower later sued the lender alleging, among other things, that lender breached its fiduciary duty to the borrower because the lender directed the consultant to suspend the borrower's monthly financial reports.[22] The First Circuit rejected the borrower's arguments, holding that the lender's involvement in the borrower's affairs was not unusual in the context of a commercial loan and did not create a fiduciary relationship.[23]

Special Relationship/Control[24]

In certain, rare instances, courts have held lenders liable based upon the lender's special relationship with its borrower. The following factors may give rise to a "special relationship": 1) when a borrower is guided by the judgment or advice of the lender or is justified in believing that the lender will act in its interest; 2) when the lender has acquired influence over the borrower and has abused that influence; 3) when the parties have worked together toward a mutual goal for a long period of time; 4) when the lender knows or has reason to know that the borrower is placing its trust and confidence in the lender and is relying on the lender for advice; 5) when both parties understand that a special trust or confidence was created; and 6) when there is an allegation of dependency by the borrower and a voluntary assumption of a duty by the lender to advise, counsel, and protect the borrower.

To avoid "special relationship" issues lenders should not: 1) actively participate in the management of the borrower's business; 2) give business advice; 3) instruct the borrower about which trade creditors should and should not be paid; 4) make representations to the borrower's trade creditors that would induce them to extend additional unsecured credit; or 5) depart from following their policies and procedures regarding disclosure of information to third parties. Lenders should also, within pertinent loan documents, include a clause disclaiming any partnership or co-venture relationship and expressly state that the lender has not accepted any position of trust or confidence.[25]

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[20] *Id.* at 97–99.

[21] *Id.* at 99.

[22] *Id.* at 99.

[23] *Id.* at 102.

[24] This concept of a special or insider-type relationship has also manifested itself in Bankruptcy Code specific causes of action. For example, in *Schubert v. Lucent Techs Inc. (In re Winstar Commc'ns, Inc.)*, 554 F.3d 382 (3d Cir. 2009), the Third Circuit expanded the definition of an "insider" under section 101(31) of the Bankruptcy Code to include a creditor with a "close relationship" with a debtor, and required the lender at issue to return $188 million in loan payments it had received from the debtor in the year prior to bankruptcy as a preferential transfer.

[25] *See, e.g.*, *Alpine Bank v. Hubbell*, 555 F.3d 1097, 1111–12 (10th Cir. 2009) (finding that construction loan documents permitting a lender to oversee construction did not create additional responsibilities when the underlying loan documents expressly provided that lender had not accepted any position of trust or confidence); *FDIC v. L.L. Claycomb*, 945 F.2d 853, 859 (5th Cir. 1991) (stating that there was no special relationship where parties expressly disavowed the existence of any partnership and disclaimed any sharing of losses); *Torke v. FDIC*, 761 F. Supp. 754,

Moreover, to the extent that a lender exercises significant control over a borrower, the lender may subject itself to a finding of a fiduciary or other relationship. Unfortunately, there are no precise guidelines to avoid a finding that a lender impermissibly controlled the debtor's affairs. Thus, working with a troubled borrower involves a delicate balancing act to protect your investment while also minimizing litigation risk. If a lender secures its interests in accordance with the express terms of its loan documents, courts are reluctant to find that the lender controlled the debtor.[26] Permissible actions to secure collateral and protect rights include, but are not limited to: 1) active monitoring of a deteriorating situation; 2) protecting and disposing of collateral;[27] 3) establishing a lockbox for the collection of receivables; or 4) advancing funds for operating expenses pursuant to the disbursement schedule or terms of the loan. In contrast, the following actions may lead to finding of control (and ultimately a finding of liability) for a lender: 1) involving itself in the day-to-day management and operations of the borrower;[28] 2) compelling the borrower to engage in unusual transactions; 3) appointing or directing the employment of officers or directors; or 4) owning or controlling a significant amount of a borrower's voting stock or partnership voting rights.

Equitable Subordination

The doctrine of equitable subordination, codified in 11 U.S.C. § 510(c), provides creditors with a remedy for a lender that has acted in a manner that harms creditors. Specifically, when a lender is found to have acted wrongly, its claim can be subordinated to that of other secured creditors, or even below unsecured creditors.[29] When faced with claims for equitable subordination, bankruptcy courts consider whether the conduct of the lender in relation to other creditors is or was such that it would be unjust or unfair to permit the lender to share pro rata with other creditors of equal status notwithstanding the apparent legal validity of a particular claim.[30]

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757 (D. Colo. 1991) (finding that no fiduciary relationship existed when a lender helped its borrower-developer select workers on the project, controlled the loan disbursements, required regular and frequent reports, and took an active interest in obtaining the required zoning on the property).

[26] *See, e.g.*, *Cossoff v. Rodman (In re W.T. Grant Co.)*, 699 F.2d 599, 609–10 (2d Cir. 1983) (noting that a lender was within its rights to enforce an agreement and was not in control of the borrower by "recoup[ing] the most amount of money as possible" and by closely monitoring the borrower).

[27] *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 948–50 (7th Cir.1989) (holding that that a bank was not a "controlling person" even though it directed the borrower to sell certain assets to meet its loan obligations).

[28] *See, e.g.*, *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 79 F.3d 878, 890 (9th Cir. 1996) (finding that lender that was supposed to receive a portion of debenture sale proceeds was not a controlling person, because it did not exercise day-to-day control over the company; the 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).

[29] Section 510(c) authorizes a bankruptcy court to, "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 . . . ." 11 U.S.C. § 510(c).

[30] *Mishkin v. Siclari (In re Adler, Coleman Clearing Corp.)*, 277 B.R. 520, 563 (Bankr. S.D.N.Y. 2002).

Whether a court will order the equitable subordination of a lender's claim is a fact-specific determination and varies from case to case. Following the test articulated in *Benjamin v. Diamond* (*In re Mobile Steel Corp.*),[31] or some derivation thereof, courts may equitably subordinate a claim if three conditions are satisfied: 1) a lender engaged in inequitable conduct; 2) the misconduct resulted in injury to other creditors or conferred an unfair advantage on the lender; and 3) equitable subordination is not inconsistent with the provisions of the Bankruptcy Code. Identifying inequitable conduct[32] is critical in equitable subordination cases. Inequitable conduct is commonly defined as: fraud, illegality, or breach of fiduciary duty; undercapitalization; or control or use of the debtor as an alter ego for the benefit of the claimant.[33] Inequitable conduct also includes lawful conduct that "shocks one's good conscience."[34]

Most commonly, courts subordinate liens if a lender maintains a high level of control over the debtor and there is evidence that transactions between the parties were not conducted at arm's length. There is no clear definition of what constitutes a creditor's control over its borrower.[35] In determining the issue of "control," courts consider a number of factors, including: 1) whether the lender exercises control over the borrower's voting stock; 2) whether the lender exercises managerial control, including personnel decisions and decisions as to which creditors should be

[31] 563 F.2d 692, 699–70 (5th Cir. 1977).

[32] As courts of equity, bankruptcy courts have a variety of tools to punish perceived inequitable lender conduct in addition to equitable subordination. For example, inequitable conduct may also lead to limitation of a creditor's right to credit bid the full amount of its claim at a bankruptcy auction under section 363 of the Bankruptcy Code. *See generally In re Free Lance-Star Publ'g Co. of Fredericksburg, VA*, 512 B.R. 798 (Bankr. E.D. Va. 2014) (limiting secured creditor's credit bid by over half based upon a variety of factors, including 1) the secured creditor's less than fully secured status; 2) its "overly zealous" loan to own strategy; and 3) the negative impact of its misconduct on the auction process); *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014) (finding that "cause" existed under section 363(k) to limit secured creditor's right to credit bid where creditor had chilled the bidding process by inequitably pushing the debtor into bankruptcy so that it could short-circuit the bankruptcy process to purchase the debtor's assets).

Recently, however, a decision from the *Aéropastle* case follows more closely the pre-2014 case law on section 363(k), which defined "cause" to limit credit bid rights to situations involving egregious conduct (*i.e.*, collusion). After an eight day, 14 witness trial, Judge Lane rejected the debtors' attempts to limit credit bidding in reliance on *Free Lance-Star* and *Fisker*, among others, and ruled that the secured creditor group could credit bid up to the full amount of its $150 million pre-petition secured loan. *See generally In re Aéropastle, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2016).

[33] *Official Comm. of Unsecured Creditors of Lois/USA, Inc. v. Conseco Fin. Servicing Corp. (In re Lois/USA, Inc.)*, 264 B.R. 69, 134–35 (Bankr. S.D.N.Y. 2001).

[34] *In re Adler, Coleman Clearing Corp.*, 277 B.R. at 563; *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, Adv. No. 09-00014, 2009 WL 3094930, at *8 (Bankr. D. Mont. May 12, 2009) (subordinating lenders' $232 million secured first lien position on a luxurious ski resort because lenders' commercial loans were so "overreaching and self-serving that they shocked the conscience of the Court"), *vacated by*, Case No. 08–61570–11–RBK, 2009 WL 10624435, at *1 (Bankr. D. Mont. June 29, 2009) (allowing lenders' claims and valuing collateral at $232 million).

[35] *Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners, L.P.)*, 200 B.R. 996, 1015–16 (Bankr. N.D. Ill. 1996) (explaining the "two types of control: 'de jure' control and 'de facto' control" and reasoning that "a lender usurping the power of a 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").

paid; 3) whether the relationship between the borrower and lender was the result of an arms-length transaction; and 4) whether the lender is the debtor's sole source of credit.[36] 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.[37]

If however, the non-insider has not dominated or controlled the debtor to gain an unfair advantage, "the type of inequitable conduct that justifies subordination of a non-insider's claim is breach of an existing, legally recognized duty arising under contract, tort or other area of law."[38] In commercial cases, the movant must show that the lender substantially breached its loan documents and obtained a significant advantage.[39] Absent a breach of contract, the movant must demonstrate that the lender engaged in fraud, misrepresentation, estoppel, or similar conduct that justifies the intervention of equity.[40]

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[36] A good example illustrating the type of the relationship between a creditor and a debtor that could could lead to equitable subordination is provided in the Third Circuit's opinion in *Winstar*, 554 F.3d 382 (3d Cir. 2009), discussed, *supra*. In *Winstar*, the Third Circuit affirmed the bankruptcy court's decision to subordinate the creditor's claim to the claims of the debtor's other creditors. *Id.* at 414. Prior to filing for bankruptcy, the debtor, a local and long distance telecommunication services company, entered into a "strategic partnership" through which the creditor provided substantial financing and the debtor was obligated to purchase much of its equipment from the creditor. *Id.* at 391. Thereafter, the creditor coerced the debtor into transactions that were not in its interest and used its power under the strategic partnership agreements—and specifically its threat of not allowing further draws under its line of credit—to force the debtor to purchase unnecessary equipment when the debtor lacked sufficient funds to purchase it. *Id.* at 397. In one "egregious example," the creditor "applied pressure on [the debtor] to help [the creditor] make its end of quarter numbers," even though it knew that the debtor's executives were "vehement that they are out of money and d[id] not want to spend money on products they cannot immediately utilize." *Id.* at 393. Nevertheless, the creditor ultimately "forced [the debtor] to pay $135 million for software it did not need, did not use, and had a fair market value of substantially less than the contract price." *Id.* at 398.

[37] *Bergquist v. First Nat'l Bank of St. Paul (In re Am. Lumber Co.)*, 5 B.R. 470, 477–78 (D. Minn. 1980) (holding that a secured lender exercised a substantial level of control over the debtor due to, among other things, the lender's 1) ability to obtain a controlling interest of the debtor's stock; 2) its *de facto* control over the debtor's cash flow; 3) ability to force termination of the debtor's employees; and 4) unilateral control over which other creditors of the debtor would be paid); *but see Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357–58 (7th Cir. 1990) (refusing to the subordinate the claim of a lender who had provided debtor with pre-petition and post-petition financing after it ceased providing financing to debtor two months after the petition date where the loan agreement provided for cancellation of the credit line on five days' notice); *Holt v. FDIC (In re CTS Truss, Inc.)*, 868 F.2d 146, 149 (5th Cir. 1989) (holding that a bank's alleged failure to fund notes executed by the borrower and its 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).

[38] *LightSquared LP v. SP Special Opportunities LLC (In re LightSquared Inc.)*, 511 B.R. 253, 348 (Bankr. S.D.N.Y. 2014) (internal quotations omitted).

[39] *80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.)*, 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994)).

[40] *In re LightSquared Inc.*, 511 B.R. at 348.

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. A court will subordinate the claim of a creditor engaging in proscribed behavior only to the claims of those creditors that were actually injured by the inequitable conduct.[41] Moreover, courts are unlikely to order equitable subordination when a non-insider lender (or a lender exercising virtually complete control so as to be treated as a fiduciary) has simply exercised its rights under a loan agreement.[42]

Accordingly, secured lenders should avoid developing a close financial or managerial relationship with their borrowers and crossing the line from enforcing their contractual rights to impermissibly using bargaining leverage to control the borrower's business affairs. In addition, loans should be provided on market terms, including interest rate, payment terms, and fees, to ensure that loan documents are not susceptible to subsequent challenge.

Conclusion

While it is a truism that eliminating all risk of alleged "lender liability" claims in the context of distressed commercial lending is impossible, there are many ways for a secured creditor to reasonably manage or minimize such risks. This article discusses a few of those risk management techniques viewed through the lens of reported case law and basic best practices for lenders managing troubled credits. With foresight and critical thought, many risks that at first glance may seem unforeseen, can in fact be foreseen and minimized. Armed with the right set of tools, procedures, processes, knowledge, and insight, light can be shed on variables that lead to litigation risk, allowing lenders and their advisors to manage risk in a more prudent fashion.

[41] *Official Comm. of Unsecured Creditors of Sunbeam Corp. v. Morgan Stanley & Co., Inc. (In re Sunbeam Corp.)*, 284 B.R. 355, 364 (Bankr. S.D.N.Y. 2002).

[42] *See, e.g.*, *In re Aeropostale, Inc.*, 555 B.R. at 409 (refusing to subordinate a claim of a creditor, which was an equity holder and had the ability to appoint the debtor's board members in exchange for, among other things, a $150 million loan, where the creditor did not take actions that stepped over the line into impermissible conduct to further its interest in a way that damaged the debtor or the bankruptcy estate).

What Lawyers Must Know About Cram Up Methods and Make-Whole Premiums When Representing Secured Creditors

Leyza F. Blanco
GrayRobinson, P.A.
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The discussion that follows highlights recent decisions where courts have shifted the balance of power in Chapter 11 cases from secured lenders towards debtors and junior creditors. In an environment where interest rates are increasing, secured creditors must be aware that borrowers may see increasing opportunities to reinstate loans in a cram up under Chapter 11. Borrowers may opt to reorganize and restructure their existing secured debt over the objection of a lender who may prefer an asset sale or a renegotiation of terms to reflect increased interest rates. In addition, some cases interpreting the application of make-whole provisions upon acceleration require precise language for a lender to preserve its entitlement to a pre-payment or "make-whole" premium upon the acceleration of its debt. The enforceability of a lender's make-whole provisions depends upon whether its documents preserve a make-whole pre-payment premium or cancels a make-whole redemption premium upon acceleration of debt.

I. WHAT IS "CRAM UP"?

A "cram up" reorganization is one in which junior classes of creditors impose a restructuring of senior debt without the consent of the senior debt holder(s). This can be accomplished by reinstating and decelerating the debt; repaying the debt over time with deferred cash payments equal to the value of the debt; or by providing the senior secured creditor with the indubitable equivalent of its secured claim.

In a reinstatement cram up, the debt is cured and decelerated, continues to be enforced pursuant to its pre-petition terms and maturity, and the secured creditor maintains its lien. In a market with rising rates, this could be a favorable option for Debtors. Generally, a Chapter 11 plan can provide for reinstatement of a Debtor's secured obligations on pre-petition terms if all defaults are cured leaving the secured claim unimpaired. However, there cannot be any non-curable defaults unrelated to the Debtor's financial conditions. A secured creditor's counsel must review the specific terms of the loan documents to determine whether defaults are non-curable.

If all the defaults are cured and none of the secured creditor's legal, equitable or contractual rights are otherwise altered, its class is unimpaired. The secured creditor does not get to vote on the plan. Provided the plan does not "discriminate unfairly" and is "fair and equitable," a plan may be confirmable in a cram up scenario. In the case of a cram up, a secured creditor may argue that its treatment is not fair and equitable even if it is receiving the full amount of its allowed claim.

Under 1129(b)(2)(A), for treatment of secured creditors in a plan to be fair and equitable, a creditor must retain its lien and receive deferred cash payments with a present value totaling at least the value of the collateral securing its allowed claims or the plan may provide the creditor with the "indubitable equivalent" of its allowed secured claim. When analyzing a proposal for deferred cash payments, the areas of dispute involve the length of repayment and the determination of present value. In determining present value, courts must consider the appropriate interest rate to which a secured creditor is entitled when its allowed secured claim is paid over time. The Bankruptcy Code does not provide any guidance on the appropriate method for calculation of a cram down interest rate. Courts have applied the "formula" approach, which adjusts the prime rate by a risk factor to determine the appropriate cram down interest rate. Till v. SCS Credit Corp, 541 U.S. 465 (2004).

In re Charter Communications Inc., 419 B.R. 221 (Bankr. S.D.N.Y. 2009)

In Charter, the senior lenders were owed $11.8 billion at less than the then-prevailing market interest rates. The junior lenders who were owed approximately $8 billion agreed to a debt-for-equity exchange where the junior debt was effectively erased from the debtor's balance sheet and the junior creditors got prevailing market terms on their new interests. Although the Debtor's controlling shareholder was divested of equity, voting control continued to avoid the application of the change in control provisions in the senior loan documents. Given that their debt would be reinstated at a below market rate, the senior lenders objected, arguing that certain defaults were not curable under Section 1124(2). The bankruptcy court confirmed the plan over the senior lenders' arguments that their secured claims were impaired and could not be reinstated.

II. WHAT ARE "MAKE–WHOLE" PROVISIONS

A make-whole provision allows the issuer to redeem a bond before maturity if it gives bondholders a lump-sum payment equal to the net present value of coupons they would have received had the bond not been called. A make-whole provision allows an issuer to reduce the amount of debt on its balance sheet while also limiting the bondholders' risk. Make-whole provisions are common and are meant to compensate lenders when debt is prepaid.

Make-whole premiums are triggered in several ways:

- Pre-bankruptcy, but the make-whole premium remains unpaid when the bankruptcy is filed.
- Automatically when a bankruptcy is filed.
- When the debt is paid outside the plan but during the bankruptcy period.
- When plan terms trigger the premium before the maturity date.

Make-whole provisions are often ambiguous and therefore the source of litigation. This ambiguity leads to disputes between the lender and borrower because it is unclear whether a

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make-whole premium can be added to the lender's claim. For this reason, make-whole provisions should, at minimum, clearly provide that acceleration triggers liability.

<u>In re MPM Silicones, LLC ("Momentive"),531 B.R. 321(S.D.N.Y. 2015)</u>

The 2014 ruling in Momentive suggested a turn against enforcing make-whole premiums after acceleration unless, the documents governing the plan include clear and unambiguous language to the contrary. MPM Silicones, LLC ("Momentive") filed a voluntary petition and proposed a plan where noteholders would be paid in full if their class voted in favor of the plan. If not, each class would receive "replacement notes" of equal value to their allowed claims. In re MPM Silicones, LLC, 518 B.R. 740 (Bankr. S.D.N.Y. 2014). Momentive moved for a declaratory judgment that no make-whole premium would be payable to the noteholders. Id. The noteholder creditors objected to the plan, arguing that Momentive was required to pay the make-whole premium upon voluntary redemption. Id. Momentive was not required to pay the make-whole premium because "automatic acceleration" is not voluntary redemption as defined by the notes. Id. They agreed that a lender may recover a make-whole premium following a non-optional redemption when the operative governing agreements require the payment. Id.

New York law is clear that when a lender chooses to accelerate the balance of a loan they forfeit the right to receive a make-whole premium, the exception being when the note clearly and unambiguously provides that make-whole premiums must be paid when automatically accelerated. In Momentive, the notes were found to be unclear, there being no indication that the make-whole premium was required to be paid even with automatic acceleration. The court found that Momentive's payment of the notes was not an optional redemption and they were not required to pay make-whole premiums. The noteholders pointed to a provision referencing a "premium, if any" as the basis for payment. However, the court understood the provision to mean that other provisions govern the noteholders' right to a make-whole premium.1

The Southern District of New York agreed with the bankruptcy court that the noteholder's were not entitled to make-whole premiums, finding no language clearly imposing the make-whole premium upon acceleration. The court held that acceleration caused the notes to be due, therefore, the creditors were not entitled to the premium. When acceleration is automatic, as in the case of a bankruptcy filing, there must be a clear and unambiguous provision calling for the payment of the make-whole premium included in the acceleration and/or make-whole provisions.

The appeal filed by the noteholders is currently pending in the Second Circuit.

In light of Momentive, it is important that the drafting of debt documents be precise, clear, and unambiguous. It is important that creditors purchasing the debt of troubled entities: 1) review the

[1] Although not analogous to the present case, the court noted that another exception to the general New York rule exists when the issuer intentionally defaults on its obligations to trigger acceleration and avoids the obligation to pay a make-whole premium.

documents governing the credit and 2) ensure that the make-whole provision and/or the acceleration provision is clear and unambiguous.

***In re Energy Future Holdings Corp.*, 2015 WL 4111560 (Bankr. D. Del. July 8, 2015)**[2]

Energy Future Intermediate Holdings Company LLC and EFIH Finance Inc. issued first lien secured notes and second lien secured notes. The indentures governing the notes contained standard acceleration provisions which provided that the notes would be immediately due and payable upon a bankruptcy filing. They also contained separate provisions providing that, if the notes were redeemed before specified dates, make-whole premiums would be required to be paid to the noteholders. Shortly after the filing and with the Bankruptcy Court's approval, the Debtors refinanced all their first lien notes and a portion of their second lien notes. The noteholders objected and commenced an adversary proceeding seeking to compel payment of the make-whole premiums on account of the refinanced notes. The Bankruptcy Court for the District of Delaware ruled that Energy Future Holdings Corp. was not required to pay $431 million in make-whole premiums after their chapter 11 filing accelerated their bond debt and found the notes were redeemed after acceleration. The court held that bankruptcy-caused acceleration did not constitute an optional redemption. The indenture trustee, Delaware Trust, then sought to lift the automatic stay, rescind the automatic acceleration and decelerate the debt to trigger the make-whole premiums due under their documents.

Relying on the decision in Momentive and other New York cases, the court found that it was imperative that the indenture contain clear, express, and unambiguous language calling for payment of the make-whole premium upon acceleration. In this case, the indenture contained no such language. The bankruptcy court rejected the argument that the optional redemption provision was a wholesale bar to repayment before the specified date, because the indenture distinguished between optional redemption and automatic acceleration. The court found that lifting the stay would have prejudiced Energy Future Holding's estate by causing a loss of hundreds of millions of dollars. The court stated that it was clear that, should the automatic stay be lifted, the notes decelerated, and the make-whole claim paid, such payment would substantially reduce the value of other stakeholder recoveries in the case. The loss of the noteholders under the automatic stay is, at most, the same as the loss to the estate if the stay was lifted. For this reason, the bankruptcy court found the standard was not met and stay relief was denied. In total, Energy Future Holding Corp. would have had to pay as much as $944 million in make-whole premiums3 if other noteholders sought the same relief.

On appeal, the U.S. District Court affirmed the bankruptcy court's decision. The noteholders appealed to the Third Circuit.

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[2] *See also In re Energy Future Holdings Corp.*, 527 B.R. 178 (Bankr. 2015).

[3] Allowing payment of the make-whole premiums would likely have encouraged junior bondholders to pursue make-whole premiums totaling $400 million in second-lien notes and $113 million in unsecured notes.

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***In re Energy Future Holdings Corp.*, 2016 WL 6803710 (3d Cir. Nov. 17, 2016)**

On appeal, the Third Circuit recently held that contractual make-whole premium provisions are enforceable where the obligation to repay is accelerated by a bankruptcy filing. The Third Circuit rejected the Momentive decision of the Second Circuit and refused to adopt the view that acceleration clauses negate the effect of make-whole provisions absent express language that the make-whole provisions survive acceleration.

The Third Circuit analyzed the acceleration provisions and optional redemption and make- whole provisions. The Court first examined whether the optional redemption clause was satisfied finding that there was an optional redemption resulting from the voluntary bankruptcy filing which gave the Debtor an option to reinstate the accelerated notes. Since the Debtor instead opted to refinance the notes, the Third Circuit concluded that the redemption was optional triggering the make-whole premium in contrast to the Momentive decision in the Southern District of NY. The automatic acceleration of the notes resulting from the bankruptcy filing did not negate the obligation under the optional redemption/make-whole provisions thus requiring payment of the make-whole premiums due to noteholders. The Third Circuit's opinion is clear that all provisions of an indenture should be given their plain meaning and should be enforced.

III. SAMPLE PROVISIONS

In U.S. Bank Nat'l Ass'n v. S. Side House, LLC, the court cited with approval the following provision as clear and unambiguous: "Upon the Lender's exercise of any right of acceleration . . . Borrower shall pay to Lender, in addition to the entire unpaid principal balance outstanding . . . (B) the prepayment premium calculated pursuant to Schedule A." 2012 WL 273119 *1, *7 (E.D.N.Y. 2012).

In In re AMR Corp., the Bankruptcy Court for the Southern District of New York found that under Section 4.01 of the note, U.S. Bank was not entitled to a make-whole premium based on the following language: "if an Event of Default referred to in . . . Section 4.01(g) . . . shall have occurred and be continuing, then and in every such case the unpaid principal amount of the Equipment Notes then outstanding, together with accrued but unpaid interest thereon and all other amounts due thereunder (but for the avoidance of doubt, without Make-Whole Amount), shall immediately and without further act become due and payable without presentment, demand, protest or notice, all of which are hereby waived . . . ." 485 B.R. 279 (Bankr. S.D.N.Y. 2013). In Energy Futures, the Third Circuit distinguished the acceleration provision in AMR Corp. because the make-whole premium was specifically carved out from the Debtor's obligations following acceleration precipitated by the bankruptcy filing. The indentures in Energy Futures did not provide that its obligation to pay the make-whole premium terminated upon acceleration of the debt.

What Lawyers and FAs Must Know to Represent Secured Creditors Successfully

AMERICAN BANKRUPTCY INSTITUTE

2017 ANNUAL SPRING MEETING

APRIL 22, 2017

Eric W. Anderson, *Parker Hudson Rainer & Dobbs LLP, Atlanta*

Leyza F. Blanco, *GrayRobinson, P.A., Miami*

Douglas M. Foley, *McGuireWoods, Washington, DC*

Scott B. Davis, *Grant Thornton, Charlotte*

Regulatory Issues in Commercial Lending, Restructurings and Workouts

Eric W. Anderson
Jack C. Basham
Parker Hudson Rainer & Dobbs LLP

Commercial lending, especially by banks, is heavily regulated at the federal level. These regulations influence the manner and terms upon which commercial loans can be made. Under certain circumstances, these regulations may have an even greater impact when a loan is being restructured or when a workout is underway, especially when the loan is syndicated to a group of lenders. Often these regulations contain operative terms and standards that are not defined or spelled out in any detail and, as a result, are subject to varying interpretation. Each lender may have its own institutional interpretation of the regulations, may implement the regulations differently, and, in setting safe and sound practices for the institution, may adopt requirements above and beyond what the regulations require. During the process of underwriting a loan, there usually is ample time to accommodate each lender's interpretation and application of the pertinent regulations, but, in the context of a restructuring or workout, there may be significantly less time to work out any differences among the group in how the mandate of these regulations should be applied and to satisfy each institution's policies, and these differences can preclude avenues the workout or restructuring might take.

We discuss below certain of the regulations that should be taken into account and how these regulations can impact the decision to make a loan or the course of a restructuring or workout. This paper is intended only to provide a high-level overview of selected regulatory issues facing lenders in workout situations, and is not an exhaustive treatment. References are included to aid in more in-depth research.

A. LEVERAGED LENDING

1. Background

- For obvious reasons, leveraged lending has been a concern of bank regulators for many years

- On April 9, 2001, the Office of the Comptroller of the Currency ("**OCC**"), Board of Governors of the Federal Reserve System ("**Federal Reserve**"), the Federal Deposit Insurance Corporation ("**FDIC**") and the Office of Thrift Supervision ("**OTS**") issued interagency guidance on leveraged financing (the "**2001 Guidance**"), OCC Bulletin 2001-18; Board SR Letter 01-9; FDIC Press Release PR-28-2001

- The 2008 financial crisis heightened concern over the stability of large financial institutions and led to such responses as enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") (codified in the United States Code in scattered places)

- The Dodd-Frank Act ushered in an environment of increased regulatory oversight and skepticism over the health and stability of large banks. In addressing the crisis and implementing the mandate of the Dodd-Frank Act, bank regulators targeted reducing risk across financial markets.

- One area of particular concern was leveraged lending, which had increased in volume

- On March 21, 2013, the OCC, the Federal Reserve and the FDIC issued the Interagency Guidance on Leveraged Lending (the "**2013 Guidance**"), updating and replacing the 2001 Guidance. The purpose of the 2013 Guidance was to outline principles for safe-and-sound leveraged lending activities for institutions supervised by these regulatory agencies in the wake of the 2008 financial crisis

- On November 7, 2014, in response to a number of questions from financial institutions regarding the interpretation and application of the 2013 Guidance, the OCC, the Federal Reserve and the FDIC issued the Frequently Asked Questions (FAQ) for Implementing March 2013 Interagency Guidance on Leveraged Lending (the "**2014 FAQ**")

- In February, 2015, the OCC, the Federal Reserve and the FDIC made a further attempt at clarifying the guidelines during a conference call attended by financial institutions and other industry participants

2. What is a Leveraged Loan

The 2013 Guidance does not provide a bright line test for what constitutes a "leveraged loan," but instead states that each financial institution should develop its own "policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines."

The 2013 Guidance offers examples of definitions of a "leveraged loan" used in the industry, including (i) loans the proceeds of which are used for buyouts, acquisitions or capital distributions, (ii) transactions in which the borrower's total debt to EBITDA is greater than 4 to 1 or where senior debt to EBITDA is greater than 3 to 1, in each case, without netting cash from debt, (iii) loans to borrowers that are recognized in the markets as being highly leveraged entities with a high debt to net worth ratio, and (iv) transactions in which the borrower's leverage ratios significantly exceed industry norms or historical levels.

3. Exclusion for Asset Based Loans

The 2013 Guidance states that it is not intended to apply to "asset-based loans." The 2013 Guidance indicates that this exception for "asset-based loans" does **<u>not</u>** apply when the asset based loan ("**ABL**") is just part of the entire debt structure of a leveraged borrower, such as when the borrower also has a term loan facility or bond/note indebtedness.

The 2014 FAQ offers more guidance on the application of this ABL exception:

- In response to a question of whether the 3 times senior debt or 4 times total debt would apply in all circumstances, the OCC, the Federal Reserve and the FDIC indicated that leverage, while an important indicator, is not the only factor. As an example of when compliance with a debt to EBITDA ratio may not be needed, these regulatory agencies referred to an ABL in which the financial institution does not rely solely on enterprise value for repayment.

- The exclusion applies when an ABL is the "dominant" source of ongoing funding for the borrower. i.e., the other debt of the borrower would usually be limited, or secured by tangible collateral such as real estate, machinery or equipment, but the 2014 FAQ does not define "dominant" or explain when the ABL would be deemed to dominate.

- In addition, in order to be considered an ABL and subject to this exclusion, the financial institution would need to be able to provide evidence of full monitoring consistent with asset based financings, i.e. borrowing base advances, field audits and enhanced reporting.

Even if the financial institution providing the ABL does not hold any of the borrower's debt other than the ABL, this exclusion does **not** apply when the ABL is part (but not a "dominant" part) of a larger debt structure of the borrower.

4. Scope of Guidance

- The guidance applies to any leveraged loan and to all levels of a loan structure whether committed funds or on a best efforts basis, and covers a new credit extension, a refinancing, the modification of an existing loan, a renewal or extension of a matured or maturing loan, and additional loans to the borrower, but likely does not apply to a loan that was not a leveraged loan when made but has deteriorated (so called "fallen angels") unless that loan, after it becomes over-leveraged, is refinanced, modified or extended.

- The guidance applies to leveraged loans by non-bank subsidiaries of bank holding companies, to new loans as well as loans acquired in the secondary market, and to loans originated for distribution to other lenders.

- The OCC, the Federal Reserve and the FDIC will look at the borrower's entire debt structure in determining whether a loan falls into leveraged loan status.

5. Requirements of 2013 Guidance

The 2013 Guidance directs each financial institution to develop its own policies and procedures with respect to leveraged lending, and sets forth general policy expectations, including setting limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure and industry and geographic concentrations.

The 2013 Guidance also specifies that financial institutions should consider underwriting standards, valuation standards, pipeline management, reporting and analytics, risk rating, credit analysis, problem credit management, credit review, stress-testing, conflicts of interest and reputational risk in developing its policies and procedures. With respect to those policies, the 2013 Guidance states that a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of **6 times total debt/EBITDA** would raise concerns in most industries.

In the 2014 FAQ, the OCC, the Federal Reserve and the FDIC explained that 6 times total debt to EBITDA is not a bright line test, but a loan that exceeds that limit may receive additional scrutiny by the regulators to assess the sustainability of the borrower's capital structure and repayment capacity

Even though the 2013 Guidance is intended to offer only guidelines, regulators have indicated that a failure to comply beyond a certain level could lead to sanctions

6. Implications of Guidelines

The 2013 Guidance and the 2014 FAQ leave key terms and concepts undefined and for each financial institution to develop policies and procedures, so there will be material differences from institution to institution in the interpretation and application of these guidelines. There may even be differences among the OCC, the Federal Reserve and the FDIC in the interpretation and application of the guidelines and even within a regulatory agency from the top down to the examination level.

This uncertainty has prompted financial institutions to "sit out" some deals when the proposed loan might be deemed to be a leveraged loan.

These differences in how lenders interpret and apply the guidelines may come to the fore when a loan is syndicated to a group of lenders.

- Each financial institution will have a different appetite for risk and may have a somewhat different test for what is a "leveraged loan."
- Each financial institution may have different policies and procedures for making, modifying and extending leveraged loans.
- Each financial institution will have its own "bucket" of permissible leveraged lending, the level of which will vary over time.
- These differences among institutions will affect restructurings and workouts and may even preclude some options, such as short-term extensions of the maturity of the facility

Leveraged loans are more expensive for lenders and require higher reserves, and a financial institution may be less inclined to work with the borrower, even if the financial institution has room in its leveraged lending bucket.

Within the past year or so, the OCC, the Federal Reserve and the FDIC have expressed concern about gaps between the guidelines and industry practices, so there may be closer scrutiny. Adding further uncertainty, the Trump administration could pull back some on the enforcement of the guidelines.

B. FLOOD INSURANCE CERTIFICATION

1. Background

The Flood Disaster Protection Act of 1973, 42 U.S.C. §§ 4001 et seq., requires federal financial regulatory agencies to adopt regulations prohibiting regulated financial institutions from making loans secured by real property located in special flood hazard areas unless the property is covered by flood insurance.

- This flood insurance requirement applies whether the financial institution is making, increasing, extending or renewing such a loan.

- The flood insurance requirement applies not just to the land and any buildings but also to the contents of any buildings.

- The requirements apply even if the real property constitutes boot collateral.

The regulations adopted by the OCC can be found at 12 C.F.R. §§ 22.1 et seq.; the regulations adopted by the FDIC can be found at 12 C.F.R. §§ 339.1 et seq.

2. Regulatory Requirements

When making a loan secured by real property, lender must confirm whether the property is located in a special flood zone area and, if so, confirm that flood insurance complying with federal requirements is obtained for the property, buildings and contents.

If the lender proposes to increase, extend or renew a loan secured by real property that, at the time the loan initially was made, was determined not to be in a special flood zone area, the lender must confirm that is still the case, but, in complying with this requirement, the lender may rely upon a prior determination that is not more than 7 years old.

If the lender proposes to increase, extend or renew a loan secured by real property that, at the time the loan initially was made, was determined to be in a special flood zone area, the lender must confirm that flood insurance is still in effect and that the insurance still complies with federal requirements. If the lender determines that the required flood insurance is not in effect or is inadequate, the lender may force place insurance and charge the borrower for the insurance

Penalties can be imposed if the lender is found to have engaged in a pattern or practice of violating the flood insurance requirements

3. Implications of Requirements

- Large banks are under intense scrutiny, so large banks are very focused on the flood certification requirements, but mid-level banks perhaps less so.

- Flood certification regulations are somewhat ambiguous and are written more with residential property in mind, but apply with equal force to commercial loans and properties.

- Each financial institution may interpret the regulations differently and may implement different policies and procedures to implement the regulations, some of which policies and procedures may be even stricter than the requirements of the regulations. These differences among financial institutions can become problematic when the loan is made by a group of lenders, and there is a proposal to increase, renew or extend loan.

- The flood certification process can be time-consuming and expensive depending on the circumstances, such as the number of properties subject to the lender's lien.

- The time and expense of the flood certification process may render some workout options impractical, such as short-term extensions; because of the cumbersome and slow certification process, lenders may not want, or be able within their institution, to "go back to the well" with repeated certifications for every short extension.

- Each regulated financial institution in the lending group must complete the flood certification process, but under many syndicated loan agreements only the agent may be authorized to force place insurance.

- Regulated members of the lending group may be willing to release real property collateral to avoid the cost and potential delay of flood certification and increase flexibility, but, if some members of the lending group are not regulated financial institutions, those members may have a different perspective on the real property collateral.

- Because of the headaches flood certification can cause, some large banks have turned down real estate loans and exited real estate loans they have made.

C. <u>RISK RATING (BASEL ACCORDS)</u>

1. Background

The Basel Committee on Banking Supervision has issued recommendations on banking regulations, referred to as "Basel Accords." The Basel Committee consists of representatives from 27 major finance centers (there are 4 United States agencies represented on the Committee

-- the Federal Reserve, the OCC, the FDIC and the OTS)) and attempts to regulate finance and banking practices at the international level

The Basel Accords are not binding on the committee members, and the Basel Committee does not have any enforcement authority; the members decide how and to what extent to implement the recommendations in their respective countries.

The Federal Reserve, the OCC and the FDIC have implemented the Basel Accords by promulgating regulations pursuant to authority granted by Congress, 12 U.S.C. § 3907(a)(2)

Basel I ("International Convergence of Capital Measurement and Capital Standards") adopted in 1988

Basel I was implemented in the United States through the promulgation of various regulations from the 1990's to the early 2000's

Basel II ("International Convergence of Capital Measurement and Capital Standards: A Revised Framework") adopted in 2004, with phased-in implementation by 2008 (regulations promulgated in United States in December 2007)

Basel II adopted in part to address perceived shortcomings in Basel I (which addressed credit risk but not other risks such as operational risk) by offering a variety of methods to calculate the risks of different assets.

Large, internationally active banks outgrew the simple framework of Basel I.

Implementation of Basel II in the United States was limited to the largest internationally active banks (having $250 billion or more in assets or $10 billion or more of on-balance sheet foreign exposure at most recent year end) at that time, "*Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II*," 72 Fed. Reg. 69288 (Dec. 7, 2007); "*Risk-Based Capital Standards: Advanced Capital Adequacy Framework*," 71 Fed. Reg. 55830 (Sept. 25, 2006).

Basel III ("Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems") adopted in 2010 and revised in 2013, with phased-in implementation into 2019 (regulations promulgated in United States in 2013)

Basel III adopted in part as a response to the belief that the 2007-2008 financial crisis exposed shortcomings in Basel II (even though the Basel II capital standards had not been fully implemented at that time).

In July, 2010, shortly before Basel III was finalized, Congress enacted the Dodd-Frank Act

In August, 2012, new agency regulations were proposed to implement both the Dodd-Frank Act and Basel III, "*Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*," 77 Fed. Reg. 52792 (Aug. 30, 2012).

Final rules were adopted in 2013 and 2014. See, e.g., OCC & Federal Reserve, "*Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*," 78 Fed. Reg. 62018 (Oct. 11, 2013); FDIC, "*Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*," 79 Fed. Reg. 61440 (Oct. 10, 2014).

Unlike the limited reach of the Basel II standards, these new rules set forth requirements generally applicable to most United States banking institutions.

2. Requirements of Basel Accords

Basel I

- Called for minimum capital requirements to be maintained by banks
- Directed at credit risk only, but market risk (risk of losses due to changes in market prices with on balance sheet and off balance sheet positions, includes interest rate risk, equity position risk, foreign exchange risk and commodities risk) later added to the standards to strengthen them
- Contains no explicit capital requirement for operational risk (risk of loss due to failure of internal processes or due to external events)

Basel II

- Overall framework consisted of three pillars: (i) minimum capital requirements; (ii) supervisory review; and (iii) market discipline through disclosure (allowing market participants to evaluate capital adequacy of bank based on information disclosed).
- Basel II is more risk-sensitive than Basel I and, unlike Basel I, contains separate capital requirements for credit risk and operational risk.
- Intended to improve banks' ability to absorb shocks from financial stresses, improve the management and governance of risk, and strengthen the transparency and disclosures of banks.
- Emphasizes reduction in systemic risk.

Basel III

- Focuses on four vital banking parameters of capital, leverage, funding and liquidity
- Primarily relies on methods similar to Basel II for assessing the relative risks posed by different types of assets, but more risk sensitive than Basel II
- Main changes in Basel III relate to increasing equity capital requirements for banks
- Increased common equity requirements and Tier 1 capital requirements and introduced a minimum leverage ratio (Tier 1 capital divided by assets)
- Methods of measuring **credit risk** (measuring likelihood that borrower will default during given period, the anticipated size of the loss if a default occurs, the amount of the exposure at the time of the default, and the remaining term of the exposure):
  - Standard approach

    -- Similar to method in Basel I

    -- Applied different risk weightings to different categories of assets, but with narrower categories of risk than Basel I
  - Internal ratings based approach ("**IRB**")

    -- Advanced IRB approach: Bank determines all risk inputs under its own procedures validated by bank regulator

    -- Foundation IRB: Bank determines each loan's probability of default, and bank regulator provides other risk inputs

    -- Permitted banks to use internal systems for measuring risk to calculate appropriate risk weighing for different assets
- Methods of measuring **operational risk** (includes legal risk which is defined as exposure to fines, penalties and punitive damages, but excludes strategic and reputation risk)
  - Basic indicator approach

    -- Meant for banks that have relatively less significant exposure to operational risk

    -- Bank holds capital against operational risk in amount equal to a specified percentage of the bank's average annual gross income over the three prior years

    -- Capital requirement calculated at firm level
  - Standardized approach

-- Same as "basic indicator" approach, except that capital requirement calculated for each of eight business lines

➢ Advanced measurement approach

-- More sensitive to operational risk and intended for banks with significant exposure to operational risk

-- Bank can use internal assessment procedures once those procedures have been blessed by regulators

-- Internal criteria would be expected to be rigorous

3. Implications of Basel Accords

- Riskier loans are more expensive for financial institutions to carry and work out due to capital carrying requirements. This is one significant reason that loan sales are more and more prevalent in modern practice. Bank may determine, using an age-old banking adage, that its "first loss is best loss" and sell loan on the secondary market to avoid expense and regulatory hassle of a protracted workout.

- Risk ratings and capital requirements, and the interpretation and application of these requirements, will vary among financial institutions. But the capital reserve requirements for poor risk-rated loans can be substantial, as much as 150% or more when a loan is deemed to be a non-performing asset.

- In a restructuring or workout of a syndicated loan, members of lending group will have different tolerances for risk, especially if the group contains non-regulated lenders

- Internal risk assessments will influence the strategies and options in a restructuring or workout

D. IN-SUBSTANCE FORECLOSURE

1. Background

In-substance foreclosures were first mentioned in authoritative accounting literature in June, 1977, in Paragraphs 34 and 84 of FASB Statement No. 15, "*Accounting by Debtors and Creditors for Troubled Debt Restructuring*," in which the Financial Accounting Standards Board ("**FASB**") agreed that a restructuring may be in substance a foreclosure even though the lender had not commenced formal foreclosure or re-possession proceedings, but Statement No. 15 did not identify any criteria for determining when an in-substance foreclosure would be deemed to have occurred.

In December, 1986, the SEC issued Financial Reporting Release 28, "*Accounting for Loan Losses by Registrants Engaged in Lending Activities*," (i) responding to concerns that lenders were sidestepping the fair value accounting required under FASB Statement 15 by simply not commencing formal foreclosure proceedings and (ii) setting forth criteria for determining when collateral is in substance foreclosed upon.

In April, 1990, the American Institute of Certified Public Accountants issued Practice Bulletin 7, "*Criteria for Determining Whether Collateral for Loan has Been In-Substance Foreclosed,*" (i) stating criteria essentially identical to those in the SEC release and (ii) extending the in-substance foreclosure treatment to non-SEC registered entities. See also AICPA, Practice Bulletin 10 (June 1992).

In June, 1990, the OCC issued a Bank Accounting Advisory Series addressing, among other topics, in-substance foreclosure, noting that with in-substance foreclosure the bank is the *de facto* owner of the collateral, is more exposed to the risks of ownership, and is better situated to benefit from recovery of the asset's fair value.

In May, 1993, the FASB issued FASB Statement No. 114, "*Accounting by Creditors for Impairment of Loan*," amending FASB Statements Nos. 5 and 15 and addressing, among other topic, the accounting treatment of in-substance foreclosures (a collateral-dependent real estate loan should be reported as other real estate owned ("**OREO**") and essentially narrowing the scope of in-substance foreclosure to only physical possession of the asset).

In June, 1993, the OCC, the FDIC, the Federal Reserve and the OTS issued an Interagency Guidance on Reporting of In-Substance Foreclosures, in which these banking regulatory agencies stated that losses on real estate loans that satisfy in-substance foreclosure standards must be recognized based on the fair value of the collateral but that such a loan would not be reported as OREO unless the bank had obtained physical possession of the collateral

Effective July 1, 2009, the FASB reorganized its accounting standards into the FASB Codification, the purpose being to consolidate in a single source the authoritative GAAP in the United States, superseding all existing non-SEC accounting and reporting standards for non-governmental entities

As part of this codification, the FASB issued Accounting Standards Codification Subtopic 310-40, "*Receivables,*" in which the FASB addresses, among other topics, the accounting treatment for in-substance foreclosures.

In January, 2014, the FASB issued Accounting Standards Update No. 2014-04, "*Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure*," discussing when residential real estate loan receivables should re-classified as OREO.

2. Requirements

With respect to commercial real estate, an in-substance foreclosure occurs when the lender acquires physical possession of the collateral; the lender need not have commenced formal foreclosure proceedings.

The lender must obtain "possession" of the collateral for the transaction to qualify as an in-substance foreclosure.

At time of acquisition, the loan would be removed from the books, and the asset would be recorded as OREO at fair value, less the cost to sell the asset.

3. Implications

- When a loan is deemed to have been foreclosed in substance, the asset is classified on the balance sheet differently—a non-performing real estate loan becomes OREO.
- This change in classification may affect how income on the asset is recognized.
- In developing a restructuring or workout strategy, or exercising certain remedies, a lender can trigger accounting treatment for in substance foreclosure, depending on the policies and procedures the lender has implemented. For example, under a lender's policies, reaching an agreement whereby the lender will directly collect all rents for the property could be deemed an in substance foreclosure, but having a receiver appointed to do the same thing may not.
- Each lender (and its internal audit and compliance teams) may have a different take on what events will trigger the accounting treatment for in-substance foreclosures.
- Accounting treatment could have unexpected, and unfavorable, implications for the lender, such as making the loan more expensive to maintain.
- An increase in a bank's OREO may be viewed as a red flag by banking regulatory agencies, indicating to the agencies that there may be deteriorating economic conditions, lax adherence to underwriting standards or deficient loan administration, and could bring unwanted attention.
- This accounting treatment may influence internal flexibility but does not preclude the lender from trying to work with the borrower.

E. PATRIOT ACT/KNOW YOUR CUSTOMER

1. Background

In 2001, Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Require to Intercept and Obstruct Terrorism Act ("**Patriot Act**"), Pub. L. No. 107-56, 115 Stat. 272 (2001). Section 326 of the Patriot Act authorized the Secretary of the Treasury to delegate certain duties and powers under the Patriot Act to "an appropriate supervising agency," codified at 31 U.S.C. § 5318(l).

Effective June 9, 2003, the Department of the Treasury, acting through the Financial Crimes Enforcement Network ("**FinCEN**"), the OCC, the Federal Reserve, the FDIC, the OTS and the National Credit Union Administration ("**NCUA**"), issued a final rule implementing Section 326 and requiring financial institutions (i) to implement procedures to verify the identity of any person seeking to open an account, (ii) to maintain records of the information used to verify the person's identity, and (iii) to determine whether the person appears on any list of known or suspected terrorists or terrorist organizations, "*Customer Identification Programs for Banks, Savings Associations, Credit Unions and Certain Non-Federally Regulated Banks*," 68 Fed. Reg. 25090 (May 9, 2003).

Effective July 11, 2016, FinCEN issued a final rule requiring covered financial institutions to establish procedures for verifying the identities of the beneficial owners of their legal entity customers, "*Customer Due Diligence Requirements for Financial Institutions*," 81 Fed. Reg. 29398 (May 11, 2016).

This new rule regarding beneficial ownership is codified at 31 C.F.R. § 1010.230, and financial institutions must comply with this new rule by May 11, 2018.

2. Requirements of the Regulations

The regulations require each financial institution to establish a customer identification program appropriate for its size and type of business.

This program must include procedures for verifying the identity of a customer, maintaining records of the information considered in conducting that verification, comparing customer identities with government list of known or suspected terrorists or terrorist organizations, and providing customers with notice of this process.

The program must be sufficiently exacting to enable the financial institution to form a reasonable belief as to the identity of its customer.

Regulations apply to any person that opens an "account," which is defined broadly to mean a formal banking relationship established (i) to provide or engage in services, dealings or other financial transactions, including a deposit account, a transaction or asset account, a credit account, or other extension of credit, or (ii) to provide a safety deposit box or other safekeeping service or cash management, custodian and trust services, 31 C.F.R. § 1020.100(a).

Under the new rule on beneficial ownership, a "beneficial owner" can be any of the following: (i) each individual owning 25% or more of the customer's equity interests; (ii) an individual with "significant responsibility" to control, manage or direct a customer, including an executive officer or senior manager of the customer or any other individual who regularly performs similar functions, or (iii) the trustee, if a trust holds, directly or indirectly, 25% or more of the equity interests of the customer, 31 C.F.R. § 1010.230(d).

3. Implications of the Regulations

- The regulations specify minimum requirements for an acceptable customer identification program, but leave it to the financial institutions to design the program, and financial institutions have the discretion to decide whether to impose requirements beyond the minimum regulatory requirements.

- For example, the regulations specify that the financial institution should verify the customer's identity within a reasonable time after the "account" is opened, but a financial institution may adopt procedures that require this verification be completed before the "account" is opened.

- When speed in completing a transaction is vital, complying with these requirements can be troublesome.

- The individuals within the financial institution responsible for collecting and verifying this information are often not the same people working on the loan transaction and may have their own timetable for completing the verification; the KYC team therefore may not have the same sense of urgency as the deal team and counsel.

- Even when the entity establishing the "account" is an existing customer of the financial institution, this process is still undertaken.

F. UNFAIR, DECEPTIVE AND ABUSIVE ACTS AND PRACTICES

1. Background

The Federal Trade Commission (the "**FTC**") was created in 1914 for the primary purpose of breaking up monopolies and protecting the public from the effects of monopolies, but the FTC's mandate was to challenge "unfair competition," which broad concept was intentionally left undefined. Banks were excluded initially from the FTC's enforcement authority, FTC Act, 38 Stat. 717, 719.

The FTC Act was amended in 1938 to shift the focus of the FTC to a certain extent from unfair competition to protecting consumers from unfair or deceptive acts or practices ("**UDAP**"), Wheeler-Lea Act, 52 Stat. 111 (1938), but banks were still excluded from the FTC's enforcement authority.

Beginning in the 1960's, states began enacting statutes prohibiting unfair or deceptive trade practices or acts, often based upon the Uniform Deceptive Trade Practices Act or the Model Unfair Trade Practices and Consumer Protection Law.

In 1975, Congress amended the FTC Act to require each banking regulatory agency to create a consumer affairs division to address complaints against banks under the FTC Act and to require the Federal Reserve to promulgate regulations defining unfair or deceptive practices and setting forth requirements to prevent violations, FTC Improvement Act of 1975, 15 U.S.C. § 57a(f). The Federal Reserve and the FDIC confirmed their authority to enforce Section 5 of the FTC Act against state-chartered banks through Section 8 of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b)(1), (e)(1) & (i)(2), Letter from Chairman Alan Greenspan to Representative John J. LaFalce (May 30, 2002); FDIC Financial Institution Letter 57-2002 (May 30, 2002);

Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Unfair or Deceptive Acts or Practices by State-Chartered Banks (March 11, 2004).

In February, 2005, the OCC issued guidelines for national banks regarding safe and sound practices for residential mortgages, OCC, "*OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices*," 70 Fed. Reg. 6329 (Feb. 7, 2005).

Following the lead of the FTC and acting pursuant to the directive in Section 18(f)(1) of the FTC Act, the Federal Reserve Board, the OTS and the NCUA had issued regulations pursuant to the FTC Act substantially similar to the FTC's Credit Practices Rule (16 C.F.R. §§ 444.1 et seq.) -- 12 C.F.R. §§ 227.11 et seq. (part of Regulation AA); 12 C.F.R. §§ 535.1 et seq. (savings associations); 12 C.F.R. §§ 706.1 et seq. (federal credit unions).

The Dodd-Frank Act, enacted in 2010, repealed the authority of the Federal Reserve, OTS and the NCUA to promulgate regulations under the FTC Act, Section 1092(2) of the Dodd-Frank Act, amending 15 U.S.C. § 57a(f).

In July, 2011, the Consumer Financial Protection Bureau ("**CFPB**") was created to spearhead federal efforts to regulate financial/banking products and services and was granted independent authority to issue regulations prohibiting unfair, deceptive or abusive acts or practices. The CFPB is an "independent" bureau in the Federal Reserve System and is not subject to Congressional appropriations (CFPB receives a certain percentage of the annual earnings of the Federal Reserve System).

In August, 2014, the Federal Reserve, the CFPB, the FDIC, the NCUA and the OCC jointly issued guidance noting that the agencies' credit practices regulations had been repealed but emphasizing that these agencies would still pursue acts or practices deemed to violate Section 5 of the FTC Act and Sections 1031 and 1036 of the Dodd-Frank Act, including acts or practices described in the repealed credit practices regulations, and that the CFPB had the authority to enforce the FTC's Credit Practices Rule against the financial institutions within its jurisdiction, Interagency Guidance Regarding Unfair or Deceptive Credit Practices (August 22, 2014); see "*Identification of Enforceable Rules and Orders*," 76 Fed. Reg. 43569 (July 21, 2011); 12 U.S.C. § 5581(b)(5)(B)(ii); FDIC Compliance Examination Manual, Title VII (December, 2016).

2. Requirements of UDAAP Laws

Section 5 of the FTC Act applies to all persons engaged in commerce.

Section 5 of the FTC Act prohibits unfair or deceptive acts and practices and unfair methods of competition in or affecting commerce, 15 U.S.C. § 45.

In 1972, the Supreme Court articulated a test for the FTC to use in determining whether an act or practice was unfair, under which the act or practice would be deemed unfair if it (i) offends public policy or at least is within the penumbra of some common law, statute or other established concept of unfairness, (ii) is immoral, unethical, oppressive or unscrupulous, or

(iii) causes substantial injury to consumers, Federal Trade Commission v. The Sperry & Hutchinson Co., 405 U.S. 233, 92 S. Ct. 898, 31 L. Ed. 2d 170 (1972).

In 1980, the FTC adopted a somewhat narrower view of its statutory mandate, stating that an act or practice would be deemed unfair if (i) the act or practice caused substantial injury, (ii) the injury was not outweighed by any countervailing benefits to consumers or competition that the act or practice produces, and (iii) the injury is one that consumers could not reasonably have avoided, Federal Trade Commission, FTC Policy Statement on Unfairness (Dec. 17, 1980).

In 1983, the FTC issued a policy statement on deception, in which the FTC stated that the following elements will be considered in determining whether an act or practice is deceptive: (i) whether the act or practice is likely to mislead; (ii) whether the act or practice is reasonable from the perspective of a consumer or group of consumers; and (iii) whether the act or practice is material, meaning whether the act or practice is likely to influence or otherwise affect consumer conduct or decisions, thereby resulting in injury, Federal Trade Commission, FTC Policy Statement on Deception (Oct. 14, 1983). In this policy statement, the FTC observed that public policy should be used only sparingly as a basis for deeming an act or practice to be unfair.

In 1994, Congress codified the FTC's Policy Statement on Unfairness, but, in doing so, Congress stated that "public policy considerations may not serve as a primary basis for such determination," 15 U.S.C. § 45(n).

On several occasions, beginning in March, 2002, the OCC issued guidance on unfair or deceptive acts or practices, OCC Advisory Letter AL 2002-3, "*Guidance on Unfair or Deceptive Acts or Practices*" (March 22, 2002); OCC Advisory Letter AL 2004-4, Secured Credit Cards (April 28, 2004) (stern warning on terms of secured credit cards) (later replaced by Comptroller's Handbook—Credit Card Lending); OCC Advisory Letter AL 2004-10, "*Credit Card Practices*" (September 14, 2004) (guidance on other credit card practices) (later replaced by Comptroller's Handbook—Credit Card Lending); OCC Bulletin 2005-3, "*OCC Guidelines Establishing Standards for Residential Mortgage Lending Practices*" (February 2, 2005).

The Dodd-Frank Act prohibits unfair, deceptive or abusive acts and practices, Dodd-Frank Act §§ 1002, 1031 & 1036(a), 12 U.S.C. §§ 5481, 5531 & 5536(a). Under the Dodd-Frank Act, an act or practice is deemed "unfair" when (i) it causes or is likely to cause substantial injury to consumers, (ii) the injury is not reasonably avoidable by consumer, and (iii) the injury is not outweighed by countervailing benefits to consumers or competition, Dodd-Frank Act §§ 1031 & 1036, 12 U.S.C. §§ 5531 & 5536.

An act or practice is deemed to be deceptive when (i) the act or practice misleads or is likely to mislead consumers, (ii) the consumer's interpretation is reasonable under the circumstances, and (iii) the misleading act or practice is material, a standard "informed" by the same standard under Section 5 of the FTC Act, CFPB Supervision and Examination Manual ("CFPB Exam Manual") at UDAAP 5 (October 2012).

Title X of the Dodd-Frank Act also expanded the UDAP provisions under the FTC Act to include "abusive" acts or practices ("**UDAAP**"), defined as an act or practice that (i) materially interferes with the consumer's ability to understand a term or condition of a financial product or service or (ii) takes unreasonable advantage of (a) a lack of understanding on the part of consumer of the material risks, costs or conditions of the product or service, (b) the inability of the consumer to protect its interests in selecting or using the financial product or service, or (c) the reasonable reliance by the consumer on the regulated entity to act in the interests of the consumer, Dodd-Frank Act § 1031(d), 12 U.S.C. § 5531(d); see CFPB Exam Manual at UDAAP 9.

The Dodd-Frank Act also includes aider and abettor liability (persons who knowingly or recklessly provide substantial assistance to a regulated entity committing an unfair, deceptive or abusive act or practice), 12 U.S.C. § 5536(a)(3).

3. Implications

- UDAAP laws are very broad and amorphous and have far reaching implications. While the laws are designed to protect "consumers" and therefore have primary application to consumer lending, anecdotal evidence suggests similar standards being applied, for example, to commercial debt collection practices.

- There need not be a clear violation of a banking or consumer finance law for the FTC or banking agencies to take action, only that the act or practice is deemed to be unfair, deceptive or abusive and to injure consumers.

- Scope of the UDAAP laws defined primarily through enforcement actions.

- Compliance with UDAAP laws presents challenges for financial institutions, and compliance strategies used in the past may not be as effective now.

- Federal banking agencies have used UDAAP laws increasingly and aggressively to challenge what the agencies believe are bad business practices.

- One recent example is the enforcement actions taken by the OCC, the FDIC and the CFPB against Citizens Bank after an investigation revealed that during an extended period Citizens Bank allegedly (i) had retained funds from discrepancies in bank accounts when the account receipts did not match the money actually transferred, (ii) had billed some customers for identity protection products the customers never received, and (iii) had engaged in unfair or deceptive practices with respect to a debt cancellation product. Pursuant to Consent Orders, Citizens Bank agreed to pay $11 million in refunds to customers and $20.5 million in fines, Consent Order dated August 11, 2015, *In the Matter of RBS Citizens Financial Group, Inc. (n/k/a Citizens Financial Group, Inc.), RBS Citizens, N.A. (n/k/a Citizens Bank, N.A.) and Citizens Bank of Pennsylvania*, Administrative Proceeding File No. 2015-CFPB-0020; Consent Order for a Civil Money Penalty No. 2015-089, dated August 7, 2015, *In the Matter of RBS Citizens, National Association, n/k/a Citizens Bank, National Association*, AA-EC-2014-109; Order for Restitution and Order to Pay Civil Money Penalty dated August 12, 2015, *In the Matter of Citizens Bank of Pennsylvania*, FDIC 14-0336k & FDIC 14-0337b.

- Trump administration may take steps to curtail authority of CFPB.

The Hipster Brewing Company ("HBC") is a craft brewery that opened in the fall of 2014, the crest of the craft brewing wave. Mullett and Devans, the co-owners of HBC, are former home-brewers who have no previous business or commercial brewing experience. Further, neither Mullet nor Devans have ever worked in the craft brewing industry. Nonetheless, armed with an overly optimistic business plan, Mullet and Devans emptied their savings; convinced several friends and family members to invest in their start-up brewery, including Devans' father, a brain surgeon and frat-boy for life; and obtained a $1.5 revolving line of credit from Salamander Bank (the "Bank") in June 2014.[1]

Mullett and Evans used the Bank loan to rent over-sized and ill-equipped factory space in a transitioning neighborhood in Atlanta, Georgia from the Industrial Commercial Group ("Landlord"). HBC's lease with the Landlord is set to expire in January 2024. HBC also used the loan proceeds to buy state of the art, environmentally (and hipster) friendly brewing equipment from a manufacturer in Belgium.

From day 1, HBC has been plagued with issues. It opened its doors over 9 months late, suffered from quality control issues, and dealt with significant construction cost overruns. Amid these issues, HBC found itself: (i) stuck with a mediocre, inconsistent product; (ii) with no significant market demand for its products; and (iii) lost in the highly competitive, overly-saturated craft beer market. HBC repeatedly begged for additional investment from its investors for two years. The investors covered a portion of HBC's requests, but refused to fund operational, production, and marketing initiatives that would have dramatically increased HBC's points of distribution and revenue. The Bank was also unwilling to lend any more money outside of the committed, mandatory line of credit disbursements as its current collateral package did not cover HBC's outstanding indebtedness.

HBC has never broke-even from operating income. As of August 1, 2016, HBC quit paying its monthly payments to both the Bank and the Landlord. HBC currently owes the following amounts: (i) $1.1 million on the Bank loan (plus interest, fees, and expenses); (ii) 9 months in back rent to Landlord; (iii) $50,000 in credit card debt; and (iv) $250,000 in unsecured trade debt (such as suppliers, utilities, etc.).

On August 15, 2016, Ed Giglio, a loan officer with the Bank, contacted Mullet and Devans regarding their now past due BBA loan. Giglio, who had burned his taste buds in an unfortunate hot soup incident, was an HBC frequenter. Instead of issuing a default and reservation of rights letter pursuant to bank protocol, Giglio looked the other way for four

[1] The Bank loan is guaranteed by the Beer Brewing Administration (the "BBA"), a newly-formed government agency dedicated to the promotion of small breweries. The BBA occupies the CFPB's former headquarters. The loan is secured by Mullet's and Evan's personal guarantees and by a lien on all of HBC's current and after acquired equipment, inventory, and receivables. The line of credit required an initial $500,000 mandatory disbursement, and mandatory $150,000 disbursements every 6 months thereafter.

months to ensure his complimentary beer supply.[2] In December, Giglio, pressured by Bank management, finally sent a notice of default letter and requested that HBC send audited financial statements and a revised business plan for the Bank to evaluate the prospects of a forbearance. HBC did not qualify for a forbearance pursuant to the Bank's loss mitigation protocols. Giglio, nonetheless, verbally promised to forbear in exchange for a keg of his favorite HBC beer—the "Hangry".

Despite Giglio's promises (and HBC's delivery of several Hangry kegs), the Bank never signed HBC's proposed forbearance agreement. The Bank further refused to honor the December 2016 disbursement on the line of credit as a result of HBC's payment defaults.[3] On January 1, 2017, the Bank's vice-president forcefully recommended that HBC hire a chief restructuring officer ("CRO"). The Bank's loan documents contain no right to appoint a restructuring officer upon the occurrence of an event of default.[4] Unbeknownst to HBC, the CRO is a retired former loan officer of the Bank and is an avid wine drinker who hates beer (especially craft beer).

HBC, pressured by the Bank, appointed the CRO on January 3, 2017. The CRO, after consultation with HBC, pays himself his fees, and the Bank certain interest payments. The CRO also determines that it is necessary to conserve cash and doesn't authorize (temporarily) HBC to make payments to any other creditors unless absolutely critical to minimal operations. At the protest of Mullet and Evans, CRO exercises significant discretion over whom to hire and fire and over the beer production schedule. CRO also appoints 2 "bank approved" members to the newly-formed Board of Directors.[5] Nonetheless, CRO is ultimately unsuccessful in his efforts to reform Mullett and Devans or streamline HBC's operations and business plan to break-even.

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[2] **All red text serves as a key to tie this hypothetical to recommendations or case law cited in Douglas M. Foley's article entitled *Anticipating Lender Liability Claims—Predicting Punches* (the "Foley Article"). Here, Giglio's actions should be examined through the lens of the recommendations contained on page 3 of the Foley Article regarding precautionary steps for distressed relationships and forbearance agreements. The reason for Giglio's departure from Bank policy should be documented in writing in HBC's loan file and supported by business judgment. It is unlikely that Giglio's business judgment would be defensible in a later lender liability lawsuit. Giglio's delay in enforcing the Banks' rights could also create a course of dealing issue that the Bank would have to later disavow.**

[3] **Remember, the subsequent disbursements are mandatory and the Bank has not yet issued a default letter. Thus, is the Bank's refusal to fund appropriate here? Would it change your analysis if the Bank had the right to refuse to disburse these funds if an event of default had occurred and was continuing? *See* Foley Article, n. 13 and accompanying text.**

[4] The loan documents are, instead, notably silent regarding the Bank's rights upon default.

[5] **This section of the hypothetical is designed to raise an issue regarding how much control is too much. Here, was the Bank authorized to appoint a CRO or did it exert unfair pressure? Was the CRO qualified to act in that capacity? Was the CRO conflicted due to his hatred of beer and former ties to the Bank? Were the CRO's actions fair and**

Unsatisfied with HBC's progress, on April 1, 2017, the Bank issued a default letter for HBC's multiple payment defaults and swept HBC's operating account (a common law right that the Bank had never enforced) prior to the expiration of the cure period.[6] The Bank then told HBC that it would not loan any further money under any circumstances unless and until HBC filed for bankruptcy and shopped the business for sale. HBC acquiesced to this demand on April 8, 2017. During this time, the Landlord had also agreed to the Bank's plan as HBC's space is retrofitted for a brewery and has no logical alternative users in its current condition, not to mention that the lease provides for above-market rent.

Following the petition date, HBC proceeded with a competitive sale process. Mullett and Devans hoped that they could raise sufficient funds from Dr. "Daddy" Devans and others to fund an insider purchase to a newly formed "Newco" to acquire HBC's assets free and clear. Unbeknownst to HBC, the CRO had used his time pre-petition to gather significant insider information regarding HBC's finances, secret beer recipes, and operations. CRO then conveyed this information to Land Locked City Brewing, a larger, more competitive industry player, and convinced them to bid for HBC's assets. The Bank and Land Locked have a very profitable business and lending relationship.[7] The Bank has no real desire to foreclose on its collateral and prefers a sale route.

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appropriate? For cases discussing similar issues, please reference footnotes 16 through 23 in the Foley Article. The paragraphs related to the CRO are also designed to raise issues as to whether the Bank might be considered an insider in HBC's bankruptcy case, *see id.* at n. 24 and accompanying text, and whether the Bank now has a special relationship with its borrower, *id.* at nn. 25, 27, 28 and accompanying text.

[6] Following the submission of the Foley Article, the United States Bankruptcy Court for the Eastern District of New York issued an opinion implicating many of the lender liability issues discussed therein. For a good discussion of whether various bank actions should result in the imposition of lender liability, please see *Citibank, N.A. v. Bombshell Taxi LLC (In re Hypnotic Taxi, LLC)*, Adv. P. No. 15-01185, 2017 WL 1207471 (Bankr. E.D.N.Y. Mar. 30, 2017).

Please note that the Bank continually fails to comply with its contractual requirements by, for example, exercising remedies before the expiration of the cure period. Further, the Bank's loan documents are silent on its remedies upon default. What impact does this have on your analysis of whether the Bank acted properly here? While a bank generally has a common or state law right to offset, it is preferable to further define that right in the loan documents.

[7] Are the Bank's actions appropriate? *See* Foley Article, n. 17 and accompanying text.

At the auction, Land Locked outbids Newco, with a bid sufficient to pay the Bank in full and pay most administrative claims. Giglio discovers the Bank's actions and conveys them to Mullet and Devans over a pint of the Hangry……[8]

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[8] **Based upon the Bank's actions, if Mullet and Devans moved to equitably subordinate the Bank's claims, do you think they will be successful? What other bankruptcy-specific causes of action may be available to Mullet, Devans, or the UCC? *See id.* at nn. 29–42 and accompanying text.**

If Giglio had warned Mullett and Devans of the Bank's actions prior to the auction and the Bank had decided to participate in the auction, do you think a motion to limit the Bank's right to credit bid would have been successful? *See id.* at nn. 32, 42 and accompanying text (discussing *Free Lance-Star*, *Fisker*, and *Aeropastle*).