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The Anatomy and Proliferation of Fraud-Based Lender Liability Claims

The rise in corporate loan defaults has resulted in a resurgence of fraud-based claims that aim to attack the validity and enforceability of credit facilities and corporate lending products, and to emasculate long-standing protective terms and conditions that lenders historically relied upon both to ensure consistent enforcement of their rights and to avoid protracted litigation, costly discovery, and the unpredictability of trials. At the same time, the attack on the financial industry's credibility and integrity, especially in the areas of sub-prime lending and residential mortgage backed securities, has provided commercial borrowers and their counsel much fodder for their own fraud-based defenses and claims against their lenders. This article analyzes how recent decisions have addressed these claims and lender liability to such challenges, and then suggests ways lenders can mitigate risks during the underwriting, administration, and enforcement of commercial loans.

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The demise of residential lending and the toxicity of residential mortgage backed securities, collateralized debt obligations, and similar financial products have been the subject of countless articles, books, television shows, and even full-featured movies in recent years. Many Americans can speak personally about the adverse impact they have experienced due to the sub-prime lending frenzy and the residential real estate market that sparked the recession and left a lackluster economy that continues today. Jurors, lawyers, and litigants carry these personal experiences into the courtroom—and are relying on them in evaluating and litigating claims against financial institutions. The onslaught of public, regulatory, and judicial criticism for a variety of alleged and admitted missteps involving residential lending, investment practices, and/or predatory lending are beginning to impact general commercial disputes.

Litigants are quick to capitalize on the criticisms that financial institutions and their executives unfairly evaded proper scrutiny for prior actions, investment strategies, and business choices. For example, United States District Judge Jed Rakoff, a leading authority on securities laws and white collar crimes in the Southern District of New York, while presiding over the civil fraud trial against Bank of America Corp. (BoA) for allegedly false statements made to Fannie Mae and Freddie Mac by BoA's Countrywide Financial subsidiary, boldly declared that the "failure of the government to bring to justice those responsible for such a massive fraud speaks greatly to weaknesses in our prosecutorial system that need to be addressed."[1]

Judge Rakoff is not alone in his views; there are constant reports in the press and rulings in courtrooms throughout the country addressing illicit

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[1] Jed Rakoff, Letter (NY Review of Books, Jan. 9, 2014), available at http://www.nybooks.com/articles/archives/2014/jan/09/financial-crisis-why-no-executive-prosecutions/.

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trading activities, predatory lending, and other institutional failures that have, in many minds, eroded the credibility and integrity of our financial industry.

Various court proceedings nationwide reveal that commercial borrowers are taking a page from these criticisms, adopting and sculpting defenses to enforcement actions that mimic those being articulated by residential borrowers and residential mortgage backed securities (RMBS) investors, and insisting that the lender must be compelled to modify or significantly alter the terms and conditions of the loan.

Commercial borrowers are more frequently asserting fraud-based defenses or claims predicated on the argument that they were induced to enter into commercial credit agreements, to pledge additional collateral, or to commit to additional financing on false pretenses or misrepresentations, and that their lenders should be foreclosed from being able to enforce the credit facilities.

Recent decisions reveal that commercial borrowers are heavily relying on these fraud-based defenses and claims to delay, hinder, and impede the lender from entering an expedited judgment or foreclosing on collateral until discovery is permitted.

Consequently, commercial borrowers, and more particularly, their counsel, are feverishly attempting to capitalize on various adverse rulings and anti-bank sentiment to avoid or evade enforcement and collection. Recent decisions reveal that commercial borrowers are heavily relying on these fraud-based defenses and claims to delay, hinder, and impede the lender from entering an expedited judgment or foreclosing on collateral until discovery is permitted.

In light of the proliferation of these defenses and claims, this article first analyzes the elements and weaknesses of such claims and related lender-liability legal challenges, and then offers practical suggestions to mitigate risks during the underwriting, administration, and enforcement of commercial loans.

INTRODUCTION TO FRAUD-BASED LENDER LIABILITY CLAIMS

Commonly Asserted Claims. With the rise in commercial defaults, recent court decisions demonstrate that borrowers and corporate guarantors are quick to lay blame on their lenders for contributing to—or even precipitating—the loan default. Mimicking complaints asserted in the residential mortgage lending context, commercial borrowers and guarantors are increasingly resorting to defending enforcement claims or affirmatively seeking damages based on allegations that the lender committed some act of fraud or fraudulently induced them to enter into the loan.

This category of lender liability claim typically is predicated on the argument that the lender either intentionally or recklessly induced the borrower to enter into the initial lending relationship, or, during the loan administration or workout period, to have undertaken obligations or to have pledged additional security on representations or promises that the borrowers later claim are false. Borrowers claim that, given these fact-based allegations, (1) they deserve an opportunity for detailed document discovery, and (2) such allegations should preclude the lenders' attempts to secure summary judgment or the right to liquidate collateral.

Common Lender Defenses. Commercial credit facilities are generally designed to preclude any sort of inducement or reliance claims with a number of integrated, enforceable terms and conditions. These include, for example, merger, integration, and parol evidence clauses, the cumulative effect of which precludes parties to the financing agreement from arguing that there is an enforceable agreement or promise that exists beyond the four corners of the credit facility.

Merger and Integration. A merger clause quite literally provides that all prior agreements and understandings between the parties are merged into the final signed agreement, and that agreement supersedes any and all such prior agreements and understandings.[2] The specific language utilized is important in determining whether all prior statements, promises, and agreements are encompassed and contemplated by the clause.[3]

Parol Evidence Rule. Generally, the "parol evidence rule forbids the reception of evidence which would vary or contradict the contract, since all prior negotiations and agreements are deemed to have been

[2] Goldman, Sachs & Co. v. City of Reno, No. 13-15445, 2014 U.S. App. LEXIS 5894 (9th Cir. Mar. 31, 2014).

[3] "[A] general merger clause—one that does not disclaim 'the existence of or reliance upon specified representations'—will not bar extrinsic evidence of fraudulent inducement." St. Paul Mercury Ins. Co. v. M&T Bank Corp., No. 12-cv-6322, 2014 U.S. Dist. LEXIS 20839, at *13 (S.D.N.Y. Feb. 19, 2014) (citations omitted); see also Dallas Aerospace, Inc.v. CIS Air. Corp., 352 F.3d 775, 785 (2d Cir. 2003) ("A disclaimer is generally enforceable only if it tracks the substance of the alleged misrepresentation.").

merged therein."[4] Where "a written contract is clear and unambiguous on its face, extraneous evidence cannot be introduced to explain its meaning."[5] For example, under Mississippi law, parol evidence may be admitted only to explain terms where a document is ambiguous or incomplete.[6]

Acknowledgement of Understanding and Counsel Review. These provisions simply provide confirmation and likely a representation that the borrower and guarantor read through the entire document, fully understand its terms, and have reviewed the agreement with counsel. These provisions are utilized to combat arguments that the borrower failed to read or comprehend the agreement's terms.

Waivers of Defenses, Setoffs and Counterclaims, and Release of Claims. "Waiver is the intentional relinquishment of a known right."[7] Borrowers and guarantors are routinely requested to provide waivers and releases at certain milestones during the loan administration, or when entering into a forbearance or extension agreement.[8] "Contractual terms may be waived, both expressly and implicitly, by the party to whom the term benefits."[9] "The elements of waiver are: (1) the existence at the time of the waiver of a right, privilege, advantage, or benefit which may be waived; (2) the actual or constructive knowledge of the right; and (3) the intention to relinquish the right."[10] "The waiving party must possess all of the material facts for its representations to constitute a waiver."[11]

While courts nationwide generally recognize the importance of enforcing these contractual provisions, as discussed below, certain recent cases have questioned the bedrock of these tested and tried provisions. These decisions have the potential to materially impair lenders from being able to insulate themselves from fraud-based inducement claims.[12] Accordingly, a lender that faces any such claims typically will rely upon these market standard protective provisions in the credit facilities and related legal arguments to dismiss the claim.

PROSECUTING FRAUD-BASED LENDER LIABILITY CLAIMS

Fraud-based lender liability claims are similar in nature and in pleading elements. Each relies on a material misrepresentation or omission that induced the borrower into the lending relationship, or from taking or forbearing from taking certain action, that resulted in calculable damages.

Fraudulent inducement claims typically follow a similar script, laying blame on the lender for inducing the loan transaction, a pledge of additional collateral, or capital infusions based on a promise or statement that is alleged to have been false when made. Such claims appeal to a court's sense of fairness and equity; claimants attempt to reveal overbearing, deceitfully calculated, and/or predatory lending practices. The borrower's goal in making such allegations is to shift the focus of the corporate default to the lender's practices and actions in hopes of avoiding a summary disposition on the credit facility and delaying seizure

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[4] Kaldi v. Farmers Ins. Exch., 21 P.3d 16, 21 (Nev. 2001) (quoting Daly v. Del E. Webb Corp., 96 Nev. 359, 361, 609 P.2d 319, 320 (Nev. 1980)).

[5] Id. (quoting Geo. B. Smith Chemical v. Simon, 92 Nev. 580, 582, 555 P.2d 216, 216 (1976)).

[6] Epperson v. SOUTHBank, 93 So. 3d 10, 17 (Miss. 2012) (explaining that parol evidence is admissible "where a document is incomplete . . . to explain the terms but, in no event, to contradict them" and also when the contract is ambiguous, but noting that "[t]he mere fact that the parties disagree about the meaning of a provision of a contract does not make the contract ambiguous as a matter of law."). The *Epperson* court further noted, "[t]he right of persons to contract is fundamental to our jurisprudence and absent mutual mistake, fraud[,] and/or illegality, the courts do not have the authority to modify, add to, or subtract from the terms of a contract validly executed between two parties." Id. (quoting Wallace v. United Miss. Bank, 726 So. 2d 578, 584 (Miss. 1998)).

[7] Costello v. The Curtis Bldg. P'ship, 864 So. 2d 1241, 1244 (Fla. 5th DCA 2004).

[8] Where releases are part of sophisticated commercial loan documents, and where the borrower, and often the guarantor, are represented by counsel and have previously borrowed large sums, courts are less apprehensive in precluding released claims. See, e.g., Frontline Processing Corp. v. Merrick Bank Corp., No. 13-cv-3956, 2014 U.S. Dist. LEXIS 27571, at *32-33 (S.D.N.Y. Mar. 3, 2014) (granting motion to dismiss finding that fraudulent inducement claim cannot be pled as plaintiff was a sophisticated party, represented by counsel when it entered into a formal agreement containing a merger clause; also denying leave to amend since amending the claim would be futile); see also Shanley v. First Horizon Home Loan Corp., No. 14-07-01023-CV, 2009 Tex. App. LEXIS 9301 (Tex. Ct. App. Dec. 8, 2009) (affirming trial court finding that the release contained in the assumption agreement was sufficient to release all claims the Shanleys had against First Horizon).

[9] Husky Rose, Inc. v. Allstate Ins. Co., 19 So. 3d 1085, 1088 (Fla. 4th DCA 2009) (alteration, citation, and internal quotation marks omitted).

[10] Id. (citation and internal quotation marks omitted).

[11] Id. (alteration, citation, and internal quotation marks omitted).

[12] See Cohen v. Kravit Estate Buyers, Inc., 843 So. 2d 989, 991 (Fla. 4th DCA 2003) ("In fraud cases, summary judgment is rarely proper as the issue so frequently turns on the axis of the circumstances surrounding the complete transaction, including circumstantial evidence of intent and knowledge.") (citation omitted).

and liquidation of the pledged collateral.[13] To state a fraudulent inducement claim, the borrower must allege with the requisite specificity that:

- There was a material misrepresentation;
- The representation was false;
- The speaker knew, when the representation was made, that it was false or, alternatively, that it was asserted recklessly, without any knowledge of its truth;
- The speaker made the false representation with the intent that it be acted on by the other party;
- The other party acted in reliance on the misrepresentation; and
- The party suffered injury as a result.[14]

A lender faced with such a claim has an initial litigation strategy choice to make:

- It can avoid the often salacious allegations altogether and argue that, as a matter of law, the allegations, even if true, are insufficient to trump the protective language in the credit facility and operative law, thus leaving the court to draw its own inferences; or
- It can engage in a debate on the facts in an effort to demonstrate that the borrower's allegations lack merit, placing the dispute into issue and perhaps risk losing the legal arguments because the court expresses concern over the dispute and may want discovery to proceed.

The temptation for a lender to avoid engaging in retaliatory pleadings is sometimes too great, as when such claims are made, the borrower tends to question the integrity of the lending officers or the propriety of the institution's lending practices. In one recent action in the New York Supreme Court's Commercial Division, the borrower opened its complaint with the following rhetoric:

> This case involves the premeditated and predatory lending practices of KeyBank, which unjustifiably has refused to fund a 2007 construction loan. . . . KeyBank has engaged in such conduct so that Plaintiff, as borrower, will default when the $60.8 million loan from KeyBank (and the other Defendants) comes due in June 2010, thereby positioning KeyBank to foreclose on the Property, causing Plaintiff to lose its entire cash investment of over $28 million. . . . Due to KeyBank's refusal to comply in good faith with its contractual obligations, the [p]roject is doomed to fail, the [p]roperty is virtually bereft of rent-paying tenants, and, as schemed by KeyBank, Plaintiff will be in danger of defaulting when the Loan matures in June 2010. Plaintiff brings this action to redress the substantial and irreparable harm that it has and will continue to suffer as a result of the foregoing.[15]

The fraudulent inducement claim thus allows the borrower to argue that the credit facility and its terms and conditions are unenforceable as a matter of law, and that the various restrictive provisions such as merger and integration clauses, oral modification provisions, and venue and jurisdiction provisions are wholly inapplicable and thus ineffective.[16] Reduced to its core, the fraudulent inducement theory focuses on a lender's intent to persuade the borrower to act or refrain from acting (or on the lender's recklessness if a negligent misrepresentation claim). In the example above, the lender must decide whether, and to what extent, it needs to address the alleged misconduct.

If a credit facility does not provide detailed parameters of the lending relationship, the lender may need

[13] A summary disposition advantageous to the lender is a dismissal motion, also called a demurrer or motion on the pleadings. In this type of application, the movant challenges the pleading on the grounds that a claim for relief was not stated, that the requirements for specified factual allegations in fraud-type claims were not met, or that there is a legal preclusion to the claim. See Fed. R. Civ. P. 12(b). A summary judgment motion, by comparison, seeks dismissal following the close of the pleadings, and at any point before or during discovery, and contends that there is no genuine issue of material fact existing to preclude dismissal or that judgment is warranted as a matter of law. See Fed. R. Civ. P. 56(a), (c). "[T]he court must view all evidence and make all reasonable inferences in favor of the party opposing summary judgment." Chapman v. AI Transport, 229 F.3d 1012, 1023 (11th Cir. 2000) (en banc) (quoting Haves v. City of Miami, 52 F.3d 918, 921 (11th Cir. 1995)).

[14] See DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 688 (Tex. 1990). By comparison, a negligent misrepresentation claim consists of the following elements: "(1) the defendant made a misrepresentation of material fact that he believed to be true but which was in fact false; (2) the defendant was negligent in making the statement because he should have known the representation was false; (3) the defendant intended to induce the plaintiff to rely . . . on the misrepresentation; and (4) injury resulted to the plaintiff acting in justifiable reliance upon the misrepresentation." Specialty Marine & Indus. Supplies, Inc. v. Venus, 66 So. 3d 306, 309 (Fla. 1st DCA 2011) (quoting Simon v. Celebration Co., 883 So. 2d 826, 832 (Fla. 5th DCA 2004)).

[15] Stellar Corte Madera, LLC v. Keybank N.A., 28 Misc. 3d 1215(A), 1215A, 958 N.Y.S.2d 63, (N.Y. Sup. Ct. 2010) (dismissing the complaint as against Column Financial and Credit Suisse as the loan documents unambiguously released Column from liability upon assignment of the loan).

[16] The Texas Supreme Court has explained that "a merger clause—as distinct from a specific disclaimer-of-reliance clause—may not, by itself, bar an action to set aside a contract based on fraudulent inducement." Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of Am., 54 Tex. Sup. Ct. J. 822, 341 S.W.3d 323, 336 n.7 (Texas 2011); see also Trinity Indus. Leasing Co. v. Midwest Gas Storage, Inc., No. 13-cv-439, 2014 U.S. Dist. LEXIS 37282 (N.D. Ill. Mar. 21, 2014)

to address the alleged misconduct and abandon any expectation of a summary disposition.[17]

NEW LIFE FOR ALLEGATIONS OF UNDOCUMENTED PROMISES, AT LEAST IN CALIFORNIA

Alleged oral promises typically have no traction as the parol evidence rule coupled with standard merger and integration clauses contained in unambiguous loan agreements prohibit the inclusion of any evidence of the alleged oral promises.[18] However, the California Supreme Court, in *Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, re-examined this principal, and explained that it would not support dismissing fraudulent inducement claims even if the alleged inducement is barred by the terms of the loan agreement.[19]

Issues in *Riverisland.* The dispute in *Riverisland* arose after the borrower fell behind on its loan payments to the defendant credit association. The parties proceeded to restructure Riverisland's debt in a written and fully integrated restructuring agreement in March 2007. The agreement confirmed the outstanding loan balances, and the credit association agreed to forbear from taking any enforcement action until July 2007, provided the borrower pledged additional collateral and made specified payments during the forbearance period. When the payments were not made, the credit association began enforcement, at which point the borrower repaid the loan and filed claims seeking damages.

The borrower alleged that the credit association's vice president met with them *before* the agreement was signed and *promised* that the loan would be extended for two years in exchange for additional real estate collateral. The borrower, therefore, alleged that it was induced to enter into the forbearance agreement with the credit association due to the lender's oral misrepresentations of the terms contained in the written agreement and contrary to its oral promises not to enforce. The borrower also claimed it did not even read the forbearance agreement but rather executed the agreement in reliance on the promises and representations made by the credit association. Before the trial court, the credit association moved for summary judgment, and argued that the borrower could not prove its claims because the parol evidence rule barred evidence of any oral representations that contradicted the terms of the written agreement.

As discussed, while the parol evidence rule generally forbids the introduction of terms outside of the signed writing, as the signed writing is the final expression of the agreement between the parties, allegations of fraud or fraud in the inducement likely will be permitted to proceed. The credit association argued that the exception does not apply when there is a fully integrated and executed agreement as it would permit the exception to swallow the rule and upholding the claim would deprive commercial lenders from expeditiously disposing of such claims when appropriate.

The trial court agreed with the credit association and granted it summary judgment, relying on 80 years of precedent.[20] The trial court noted that a borrower cannot utilize the fraud exception to permit the admission of promises that are at "odds with the terms of the written agreement."[21]

The borrower appealed and found a sympathetic ear at the intermediate appellate court. That court reversed, finding that the prior case law only precludes claims of promissory fraud (i.e., a form of fraud in which a promise is made without any intention of performing the promise and which can form the foundation of a claim that the promisor fraudulently induced the contract). The appellate court reasoned that the alleged false statements directly impact the contents of the agreement and must be litigated fully to ascertain whether they are precluded by the terms of the agreement.

Arguments Before the California Supreme Court. On appeal to the California Supreme Court, the credit association compellingly argued in its briefs as follows:

> Plaintiffs entered into a written loan forbearance agreement with defendant. They claim defendant made oral representations, before and at the time of signing, regarding certain terms of the agreement which are directly contradicted by the terms of the signed writing. There is no question that plaintiffs had the opportunity to read the agreement before signing and discover that the terms were not the same as which they claim were represented to them orally.[22]

The credit association explained:

> [The borrower] admit[s] [it] did not review the agreement or other documents before [it] signed them. . . .

[17] Dantzler Inc. v. PNC Bank, N.A., 946 F. Supp.2d 1344 (S.D. Fla. 2013).

[18] See, e.g., Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn., 55 Cal. 4th 1169 (2013) (alleged oral promise to extend loan for two years with pledge of new collateral); Vinewood Capital LLC v. Dar Al-Maal Al-Islami Trust, 541 Fed. Appx. 443 (5th Cir. Tex. 2013) (alleged oral contract to invest $100 million in plaintiff's real estate projects).

[19] 55 Cal. 4th 1169 (2013).

[20] Bank of America etc. Assn. v. Pendergrass, 48 P.2d 6594 Cal. 2d 258 (1935).

[21] *Riverisland*, 55 Cal. 4th at 1173.

[22] Respondents' Reply Brief on the Merits at 1, Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn., 55 Cal. 4th 1169 (2013) (No. S190581).

> [The borrower] admits that [its] initials appear next to the designation of . . . additional collateral in the deed of trust. . . . [The borrower] also admits that when he actually read the forbearance agreement and deed of trust, he was able to ascertain that the forbearance term was 97 days and that [it] had pledged [additional] collateral. . . . [The borrower] presented no evidence that [it was] denied the opportunity to read the agreement and other documents before signing and discovery that the terms were not the same as the terms which [it claims the lending officer] presented to them orally.[23]

Despite all this, the California Supreme Court disregarded long-standing precedent and explained the parol evidence rule existed "to protect the *terms* of a valid written contract, [and] should not bar evidence challenging the *validity* of the agreement itself."[24] Thus, said the court, where a borrower claims the agreement itself is invalid due to an alleged misrepresentation or false promise he should be permitted to pursue his claim—notwithstanding the protective language of the credit agreement or even representations by the borrower the he read the agreement or agreed that there are no promises other than those set forth in the signed writing.

Lenders need not start packing up their toys just yet; the majority of jurisdictions continue to enforce the parol evidence rule as a bar to fraudulent inducement claims, and frown upon attempts to emasculate heavily negotiated and integrated credit facilities and related collateral documents.

The California Supreme Court made it clear, however, in a trailing footnote that it declined to "explore the degree to which a failure to read the contract affects the viability of a claim of fraud in the inducement,"[25] essentially punting on the issue of justifiable reliance.[26] Nonetheless, the damage to the lender's case was already done, since in order to prevail it would have to complete discovery and proceed to trial.

The rationale for this ruling is that a party should not be permitted to insulate itself from the consequences of its own fraud.[27] Other jurisdictions have held, to the contrary, that if "the contract was fully negotiated and voluntarily signed, [then] plaintiffs may not raise as fraudulent any prior oral assertion inconsistent with a contract provision that specifically addressed the particular point at issue."[28]

Time will reveal whether other jurisdictions will adopt the principles of *Riverisland* and convey a broad license to the defaulting borrower to challenge the validity of loan agreements solely on the argument that the lender made an oral promise that contradicts the terms of the loan agreement.[29] At a minimum, *Riverisland* and similar decisions may make it more difficult to dispose of fraud-based claims in California on a dismissal motion on the pleadings or on summary judgment.

THE MAJORITY OF JURISDICTIONS HAVE A HIGH HURDLE FOR FRAUDULENT INDUCEMENT CLAIMS

Lenders need not start packing up their toys just yet; the majority of jurisdictions continue to enforce the parol evidence rule as a bar to fraudulent inducement claims, and frown upon attempts to emasculate heavily negotiated and integrated credit facilities and related collateral documents.

In one illustrative case, *LFM Real Estate Ventures, LLC v. Suntrust Bank*, a North Carolina federal court held not only that the parol evidence rule excluded evidence of the alleged oral promises, but that the plaintiff borrowers had effectively waived their right to enforce the allegedly fraudulent oral promises by executing the amended agreements.[30] In addition, the court explained that "[p]laintiffs are sophisticated men and women, yet they maintain that it is reasonable to believe that a bank would offer an indefinite interest-only loan for a sum of $870,000."[31] The court

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[23] Respondents' Opening Brief on the Merits at 6, Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn., 55 Cal. 4th 1169 (2013) (No. S190581).

[24] *Riverisland*, 55 Cal. 4th at 1174 (emphasis in original).

[25] Id. at 1183 fn. 11.

[26] Notably, the element of justifiable reliance is not necessarily required by all jurisdictions. For instance, the Florida Supreme Court has held, "Justifiable reliance is not a necessary element of fraudulent misrepresentation." Butler v. Yusem, 44 So. 3d 102, 105 (Fla. 2010). The claim only requires "consequent injury by the party acting in reliance on the representation," and not justifiable reliance. Id. (emphasis, citation, and internal quotation marks omitted). Thus, borrowers are well advised to determine each jurisdiction's unique pleading elements before committing to a fraudulent inducement or negligent misrepresentation claim.

[27] See generally Ron Greenspan Volkswagen, Inc. v. Ford Motor Land Develop. Corp., 32 Cal. App. 4th 985, 991-93, (Cal. App. 1st Dist. 1995); Continental Airlines, Inc. v. McDonnell Douglas Corp., 216 Cal. App. 3d 388 (Cal. App. 2d Dist. 1989); Danzig v. Jack Grynberg & Associates, 161 Cal. App. 3d 1128 (Cal. App. 1st Dist. 1984).

[28] Starr v. Fordham, 648 N.E.2d 1261, 1268 (Mass. 1995) (quoting Turner v. Johnson & Johnson, 809 F.2d 90, 97 (1st Cir. 1986)).

[29] See, e.g., Audra Ibarra, "Riverisland Cold Storage, Inc. v. Fresno-Madera Production Credit Association" (San Francisco Attorney, Summer 2013), at 38, available at http://www.sfbar.org/forms/sfam/q22013/2013-review-of-recent-cases.pdf.

[30] No. 11-cv-135, 2012 US Dist. LEXIS 175439 (W.D.N.C. Dec. 7, 2012).

[31] Id. at *22.

ultimately found that the plaintiffs had not alleged facts establishing a *prima facie* case of fraud and did consider the reliance element in conjunction with the lender's request to bar the oral promises.

Thus, the sophistication of the parties appears to be a relevant—and in most cases a determinative—factor, in determining whether a fraudulent inducement claim will fail for justifiable reliance. That said, courts seem to be unwilling to turn a blind eye to what they consider to be unadulterated fraudulent conduct. As noted by a New York appellate court, "[a] party to a contract cannot, by misrepresentation of a material fact, induce the other party to the contract to enter into it to his damage and then protect himself from the legal effect of such misrepresentation by inserting in the contract a clause to the effect that he is not to be held liable for the misrepresentation which induced the other party to enter into the contract. The effect of misrepresentation and fraud cannot be thus easily avoided. If it could be the implied covenant of good faith and fair dealing existing in every contract would cease to exist."[32]

In *ACA Financial Guaranty Corp. v. Goldman, Sachs & Co.*,[33] the trial court initially denied the defendant's motion to dismiss an inducement claim, resulting in an interlocutory appeal. The Appellate Division reversed, finding that ACA's position as a "highly sophisticated" commercial entity that (1) could have accessed public and non-public information, and (2) had represented that it was not relying on representations by the defendant other than those contained in the circular, could not adequately plead justifiable reliance sufficient for the claim to survive a dismissal challenge.

ACA alleged it was fraudulently induced to issue a financial guaranty for a portion of an investment by the defendant's misrepresentation that a non-party hedge fund was taking a long position in the investment, but the Appellate Division found that ACA could have uncovered the truthfulness of the alleged misrepresentation upon inquiry. The court noted that the alleged misrepresentations were specifically contradicted by the final offering circular's disclosure, and the plaintiff's alleged reliance on such misrepresentations would have been contrary to its acknowledgment that it was not relying on any representations other than those contained in the final offering circular.

Other decisions in actions related to the ACA case have concluded that if no fraud was found in the ACA case, there could not be fraud in those cases either, where the loss was not due to a misrepresentation, but simply due to the financial crisis and its consequences. For example, in *Lorely Fin. (Jersey) No. 4 Ltd. v. UBS Ltd.*, the court dismissed the action as the plaintiff could not prove both transaction causation and loss causation in light of the financial crisis.[34]

Similarly, in *Woori Bank v. RBS Securities., Inc.*,[35] a Korean financial institution attempted to mitigate its sizeable losses by alleging that defendants' "false and misleading misrepresentations and omissions" in arranging and marketing collateralized debt obligations (CDOs) had induced Plaintiff "to invest $120 million in a series of fraudulently created and marketed collateralized debt obligations and related products."[36] Woori Bank claimed that each of the CDOs "was in reality a fraudulent investment vehicle created and exploited by Defendants to move toxic mortgages off of their balance sheet and onto those of Plaintiff."[37] Hoping to benefit from the public's general disdain of these financial products, Woori Bank incorporated and referenced in its complaint "third-party reports about RBS and other financial institutions' involvement in the RMBS market, including reports from the U.K. Financial Services Authority, the Clayton Holdings, the Financial Crisis Inquiry Commission and others."[38]

United States District Judge Harold Baer, Jr. was not impressed. He explained that

> [b]y virtue of coinciding with the turning tide in the housing market and RBS's role in structuring related securities, the deals in this case are, like most deals of that time, somewhat suspect. But not all such deals are inherently fraudulent or misleading simply because they involved subprime mortgages and the sale of what are now worthless investments that were once pitched as safe. This case is one example of a seemingly legitimate deal between financial institutions and their effort to hedge their risks. Here Woori has

[32] Jackson v. State, 210 A.D. 115, 119 (N.Y. App. Div. 4th Dep't 1924).

[33] 106 A.D.2d 494, 967 N.Y.S.2d (N.Y. App. Div. 1st Dep't 2013).

[34] 978 N.Y.S.2d 615 (Sup. Ct. N.Y. 2013). But see Loreley Fin. (Jersey) No. 3 Ltd. v. Citigroup Global Mkts. Inc., 2014 N.Y. App. Div. LEXIS 3300, 2014 NY Slip Op 3358 (1st Dep't May 8, 2014) (affirming denial of motion to dismiss fraud claim where plaintiff had pled that the facts comprising the fraud were peculiarly within defendant's knowledge and plaintiffs could not have discovered this information despite reasonable due diligence, and where unlike in *ACA Financial*, it was alleged that defendant actively concealed information).

[35] 910 F.Supp.2d 697 (S.D.N.Y. 2012).

[36] Complaint at 2, *Woori Bank v. RBS Secs., Inc,* 910 F.Supp.2d 697 (S.D.N.Y. 2012). (No. 12-cv-04254) at 2.

[37] Id. at 2.

[38] *Woori Bank*, 910 F.Supp.2d at 699.

failed to meet its pleading burden with respect to the CDOs it purchased.[39]

Many disputes are premised on compliance with loan covenants and borrowing availability, as well as whether loan provisions are clear or whether the lender, either verbally or through actions, waived certain restrictions or permitted certain violations.

One fertile ground for disputes is the calculation of borrowing availability. In one case, the borrower actually tried to rely on the merger and integration clause to compel the bank's reliance on a borrowing base certificate that calculated loan availability in its favor. The lender, in turn, sought to dismiss the borrower's claim—as well as fraudulent inducement and negligent misrepresentation claims brought against it—on the grounds that the loan agreement should govern and that calculations as to the lending formulas done correctly or incorrectly in conjunction with the closing should not be binding.[40] Ultimately, the Florida federal court concluded that the bank was not entitled to summary judgment given that the factual disputes prevented the court from determining whether or not the borrower proceeded with the loan with full understanding of the lender's lending calculations and the availability to borrow.[41]

On balance, the decisions highlight the necessity for particularity and clarity in the loan documents and the lending formulas.

In contrast, a federal court in Arkansas, after initially denying summary judgment to a lender prior to discovery, eventually opted to dismiss the borrower's fraud in the inducement claims as to lending availability. The court dismissed the borrower's claims that it was induced to enter the loan believing there would be greater loan availability as the borrower continued to benefit from the revolving loans after the loan ratios were enforced and did not raise this issue until well after events of default were declared.[42]

On balance, the decisions highlight the necessity for particularity and clarity in the loan documents and the lending formulas.

Commercial borrowers also are increasingly asserting fraud claims under state and federal deceptive trade practice laws. For instance, the Fair Debt Collection Practices Act (FDCPA),[43] amended as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, prohibits unfair, deceptive, or abusive acts or practices. The act generally applies to third-party debt collectors, such as collection agencies, debt purchasers, and attorneys who are regularly engaged in debt collection.

In *Caires v. JP Morgan Chase Bank, N.A.*,[44] the residential borrower alleged violations of the Connecticut Unfair Trade Practice Act (CUTPA) and the FDCPA as a result of the bank "using false, deceptive, and misleading statements and deceptive omissions in connection with its collection of the Plaintiff's mortgage debt . . . enticing Plaintiff to pay an extension fee and interest by promising a lower interest rate when the loan converted, [and] refusing to convert his loan to the lower interest rate as promised in the loan documents. . . ."[45] The court granted the bank's motion to dismiss, finding that its practices "did not constitute deception, fraud, predatory or otherwise egregious conduct sufficient to constitute a CUTPA claim.[46]

These consumer driven statutes are generally designed to protect consumers from deceptive debt-collection practices engaged in by debt collectors as opposed to loans the collecting creditor may have

[39] Id. at 700; see also N.J. Carpenters Health Fund v. NovaStar Mortg., Inc., 2011 U.S. Dist. LEXIS 36363, 2011 WL 1338195, *11 (S.D.N.Y. Mar. 31, 2011) ("[M]ore is required . . . than 102 pages of the subprime market melted down and Defendants were market participants, so they must be liable for my losses in my risky investment.") (internal quotation marks omitted)(dismissal of action later reversed and remanded in 709 F.3d 109 (2d Cir. 2013)).

[40] The bank, relying on Investments, Inc. v. Oakland Hills Joint Venture, 909 So. 2d 355 (Fla. 4th DCA 2005), sought to bind the borrower by arguing that the fraud claims cannot be maintained since the borrower proceeded to close the transaction. The court disagreed as the record did not demonstrate the absence of a genuine issue of material fact regarding the borrower's knowledge of the bank's positions and calculation of the borrowing availability. *Dantzler Inc.*, 946 F. Supp. 2d at 1344.

[41] Id.; see also Taylor Woodrow Homes Fla., Inc. v. 4/46-A Corp., 850 So. 2d 536, 542–43 (Fla. 5th DCA 2003) ("Moreover, the courts have held that a party may not recover in fraud for an alleged false statement when proper disclosure of the truth is subsequently revealed in a written agreement between the parties." (citations omitted)).

[42] Webster Bus. Credit Corp. v. Bradley Lumber Co., No. 08-cv-1083, 2011 U.S. Dist. LEXIS 137102 (W.D. Ark. Nov. 29, 2011).

[43] 15 U.S.C. § 1601 et seq.

[44] 880 F. Supp.2d 288 (D. Conn. 2012).

[45] Id. at 296.

[46] Id. at 301; see also LFM Real Estate Ventures, LLC v. Suntrust Bank, No. 11-cv-135, 2012 US Dist. LEXIS 175439 (W.D.N.C. Dec. 7, 2012) (holding that where the breach of contract claim had been dismissed the UDPTA claim based on breach of contract could not go forward, and since the fraud claim was also waived by plaintiffs or otherwise barred for failure to show justifiable reliance, the UDPTA claim was also dismissed).

made.[47] Even where similar state statutes are consumer driven, commercial borrowers are attempting to invoke them in commercial lending contexts.[48]

Most courts, however, rule that these and similar statutes either do not serve as a basis for private action by commercial, sophisticated parties or have significant limitations on the availability of damages.[49] Before doing so, however, courts generally are exposed to the nature of the allegations and these allegations may impact the court's views of whether the fraud-based allegations are credible and sufficiently detailed under the heightened pleading standards imposed by most state rules and under federal law.[50]

Lenders must pay close attention to the sum and substance of their communications—even those made in casual conversations with borrowers—which could be sufficient basis for a court to justify a denial of summary judgment and a prompt adjudication of the matter.

In *Jolley v. Chase Home Finance, LLC*,[51] the borrower sued the acquiring bank, alleging misrepresentation, breach of contract, negligence, and violation of California Business Code Section 17200, and sought declaratory relief, accounting, and reformation. The appellate court affirmed summary judgment on the claims for declaratory relief and accounting, but reversed summary judgment on the other claims brought against the acquiring bank. The acquiring bank had purchased the original lender's assets through a purchase and assumption agreement. The borrower dealt with a bank employee who had expressed opinions about the likelihood of Jolley receiving a loan modification. The court found that the bank employee's dealings with the borrower, specifically the prolonged communication about possible loan modification, raised a triable issue of fact as to whether the bank intended to "profit by misleading Jolley about his loan modification prospects"[52] sufficient to deny summary judgment on the misrepresentation claim.

Clear written communications and consistent application of underwriting and credit procedures will help mitigate the risk of fraud-based disputes concerning terms, conditions, and resolution paths that are not fully documented and integrated in a signed writing.

CONCLUSION

Clear written communications and consistent application of underwriting and credit procedures will help mitigate the risk of fraud-based disputes concerning terms, conditions, and resolution paths that are not fully documented and integrated in a signed writing. These disputes can significantly impact a lender's ability to prevail at trial or on appeal, and contribute to a significant rise in costs of discovery, trial, and resulting appeals. Borrowers and lenders alike, therefore, are encouraged to utilize waivers, acknowledgements, and releases whenever appropriate during the loan administration and certainly in forbearance periods and workout scenarios.

The reason for these precautions is illustrated by cases like *Armed Forces Bank, N.A. v. Double "O"*

[47] 15 U.S.C. § 1692(a)(4) (definition of creditor) and (a)(6) (definition of debt collector). By way of comparison to similar state laws, "New York courts have held that, '[t]o successfully assert a [New York General Business Law § 349] claim, a plaintiff must allege that a defendant has engaged in (1) consumer oriented conduct that is (2) materially misleading and that (3) plaintiff suffered injury as a result of the allegedly deceptive act or practice.'" City of New York v. Smokes-Spirits.com, Inc., 911 N.E.2d 834, 838, (N.Y. 2009); accord Wilson v. Nw. Mut. Ins. Co., 625 F.3d 54, 64 (2d Cir. 2010); Angermeir v. Cohen, No. 12-cv-55 2014 U.S. Dist. LEXIS 42403 (S.D.N.Y. Mar. 27, 2014).

[48] See FDCPA § 803(6); 15 U.S.C. § 1692a(6); CFPB Bulletin 2013-07, available at http://files.consumerfinance.gov/f/201307_cfpb_bulletin_unfair-deceptive-abusive-practices.pdf; see also Oswego Laborers' Local 214 Pension Fund v. Marine Midland Bank, N.A., 85 N.Y.2d 20, 647 N.E.2d 741, 744, 623 N.Y.S.2d 529 (N.Y. 1995) ("Private contract disputes, unique to the parties . . . would not fall within the ambit of [§ 349]."); Schlessinger v. Valspar Corp., 21 N.Y.3d 166, 991 N.E.2d 190, 193, 969 N.Y.S.2d 416 (N.Y. 2013) ("Section 349 does not grant a private remedy for every improper or illegal business practice, but only for conduct that tends to deceive consumers.").

[49] In addition to the deceptive business practice claims, many borrowers attempt to levy generalized allegations and claims of fraud, alleging, for example, that the lender made promises that additional loans would be made or that a default would not be called notwithstanding the existence of events of default. The claims do not typically succeed against a commercial lender because, while the facts may be superficially compelling, upon analysis, the allegations typically are too vague or the complainant is unable to adequately plead justifiable reliance. However, the jurisdiction will largely dictate whether justifiable reliance is even an element of the fraudulent inducement claim. See, e.g., *Dantzler*, 946 F. Supp.2d at 1358 n.8 (S.D. Fla. 2013) (noting that in Florida, justifiable reliance is not a necessary element of fraudulent misrepresentation and omitting it in the required elements of fraudulent inducement).

[50] See, e.g., *Webster,* 2011 US Dist. LEXIS 137102 (W.D. Ark. Nov. 29, 2011) (rejecting application of the Arkansas Deceptive Trade Practice Act because the acts complained of as being deceptive lacked validity).

[51] 213 Cal. App. 4th 872 (Cal. Ct. App. 2013).

[52] Id. at 895.

Dev., LLC.[53] *Armed Forces Bank* involved a commercial loan guaranteed by two corporate guarantors. The original loan agreement and the promissory note included market standard merger clauses in capital letters. In addition, forbearance agreements were entered into on March 9, 2010, and September 1, 2010, and both forbearance agreements included releases that released the lender from "all manner of action, causes of action, claims and demands of every kind and nature whatsoever" as of the date of the agreements.[54] When the borrower failed to pay the outstanding amount due, the lender filed suit on the loan agreement and guarantees. The borrowers included with their answer counterclaims alleging breach of contract and fraudulent and/or negligent misrepresentation. The trial court granted summary judgment for the lender on all claims, defenses, and counterclaims, noting the provision stating that all agreements were memorialized in the written agreement. The Court of Appeals, in affirming the decision, further noted the releases contained in the two forbearance agreements were valid and enforceable, and applied them to the alleged oral representations upon which the counterclaims were based as they took place prior to the execution of the releases.[55]

While there may be no way to create complete immunity from borrower claims and counterclaims, to the extent that lenders continue to take care in their communications with borrowers, and in the memorializing of the loan agreement, and obtain releases when appropriate, lenders can position themselves to be prepared to defend such claims when litigation occurs. ■

[53] No. 108,979, 2014 Kan. App. Unpub. LEXIS 5 (Kan. Ct. App. Jan. 20, 2014).

[54] Id. at *3.

[55] See also Shanley v. First Horizon Home Loan Corp., No. 14-07-01023-a, 2009 Tex. App. LEXIS 9301 (Tex. Ct. App. Dec. 8, 2009) (granting lender summary judgment where a release barred the borrower's claims); Interpharm, Inc. v. Wells Fargo Bank, N.A., No. 08-cv-11365, 2010 U.S. Dist. LEXIS 32318, 40, 2010 WL 1257300 (S.D.N.Y. Mar. 31, 2010) (examining the validity of the release provided to the lender for duress or other valid legal defense and upon finding none, upholding the release to dismiss covered claims).