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When Lenders Exercise Too Much Control

By Zachary G. Newman – April 28, 2016

Commercial lenders rightly turn to their loan documentation and applicable law to identify their available rights and remedies following a borrower's default. The exercise of these rights and remedies, however, can present material risk to a lender, especially when the circumstances support an argument that the lender exercised an unreasonable level of control over, or unduly influenced, the borrower, the guarantor or the collateral. Such actions could jeopardize the enforcement of the debt and significantly expose the lender to additional liability. As corporate and commercial loan defaults continue to experience record lows, counsel should take this opportunity to remind themselves of the pitfalls to which lenders have fallen victim when they inadvertently or deliberately exercise too much control.

What Constitutes Control?

A determination of whether a lender has exerted undue control over a borrower typically is fact-sensitive, but a number of practices could raise red flags. Control is not necessarily limited to situations in which the lender directly takes over corporate decisions or directs how collateral should be liquidated by the borrower. Rather, control is an amorphous concept and can apply whenever the lender crosses that imaginary line from being an arm's-length lender to influencing the borrower's ability to do business or impairing the collateral. For example, if the lender threatens the acceleration of a loan to influence the borrower's decisions or institutes mandatory financial or staffing plans, it is exposing itself to potential liability.

When confronted with such issues, counsel should be mindful of how and when the lender advised the borrower or guarantor, or influenced the disposition of collateral. On the one hand, a lender's "right to receive regular financial reports and monitor [the debtor's] performance, and even to limit salaries paid . . . [is] not at all unusual in the context of a commercial loan and [does] not create a fiduciary relationship." *Shawmut Bank, N.A. v. Wayman*, 606 N.E.2d 925, 928 (Mass. App. Ct. 1993). Accordingly, "a lender may offer advice and use the leverage which its position gives it vis-a-vis the debtor, without being viewed as controlling the debtor, so long as the debtor continues to operate, and the management of the debtor continues to make its own business decisions." *FAMM Steel v. Sovereign Bank*, 571 F.3d 93 (1st Cir. 2009). On the other hand, lenders that require borrowers to obtain consent before implementing decisions that could affect business operations are risking control claims. Generally, lenders should not dictate changes in the borrower's business plans, daily business practices, or credit policies.

Administering the Loan

Actions that are consistent with prevailing law and the terms of the loan agreements usually do not provide the borrower and guarantors with an ability to claim the lender acted in bad faith. For example, in *Bank of America, N.A. v. Shelbourne Development Group, Inc.*, 732 F. Supp. 2d 809 (N.D. Ill. 2010), the court noted that "Illinois law holds that parties to a contract are entitled to enforce the terms to the letter and an implied covenant of good faith cannot overrule or modify the express terms of a contract" (internal quotations and citation omitted). Similarly, in *Interpharm, Inc. v. Wells Fargo Bank, N.A.*, 655 F.3d 136 (2d Cir. 2011), the Second Circuit

affirmed the dismissal of lender-liability claims on the grounds that Wells Fargo had a right to threaten to do what it was legally entitled to do under the loan agreements.

The withdrawal of lending commitments, however, could support a control claim against the lender. For example, where a loan commitment is contingent on lending committee approval the bank is generally required to exercise good faith and meet its obligation of presenting the credit to the lending committee. *See* *Gilmore v. Ute City Mortg. Co.*, 660 F. Supp. 437, 442 (D. Colo. 1986). A failure to do so could give rise to a claim against the lender. If the lender rescinds a commitment to lend, the lender's decision-making process, rationale, and representations to the borrower likely will be scrutinized and will be the intense focus of fact discovery. *Id.*

The process of determining loan availability under commercial loans can be a source of dispute between a borrower and lender. As many revolving credit facilities and asset-based lending facilities have protocols that address daily availability, a borrower can seek to lay blame on the lender for damages incurred as a result of the lender's calculation of availability or denial of available funding. While loan facilities generally provide various and detailed formulas and standards on which lenders typically rely to administer the loan, the lender must be careful not to impose a precipitous or significant decision without adequate notice and a sufficient basis. Thus, even where the loan agreement permits the lender to take the action, the case law suggests that the lender should carefully weigh whether such action is absolutely necessary to preserve the collateral or to prevent irreparable harm. In *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759–60 (6th Cir. 1985), for example, the literal terms of the credit agreement allowed the lender to assume control over customer's receivables and operating credit availability, but the court nevertheless found that the duty of good faith required the lender to provide notice and an opportunity to seek alternative financing before curtailing financing. *See* *Cont'l Cas. Co. v. Fifth/Third Bank*, 418 F. Supp. 2d 964, 973 (N.D. Ohio 2006) (noting that "'mere failure to follow commercially reasonable banking procedures or to comply with its own policies' does not *per se* equal bad faith" and concluding the bank had acted in good faith) (citation omitted).

In *Gavin v. Sovereign Bank*, No. 06-12314, 2008 U.S. Dist. LEXIS 50405, 2008 WL 2622839 (D. Mass. June 30, 2008), affirmed in the *FAAM Steel* decision above, the borrower argued that the lender should be held responsible for the loan and other damages to the business because it controlled the borrower's operations and did so recklessly. The borrower alleged that the lender required the borrower to hire a certain accounting manager and comptroller, both of whom ultimately failed in their respective duties, and failed to cooperate with the borrower to restructure the loan. The court did not find evidence that the lender exercised unfair or absolute control over the borrower's activities, and therefore was unwilling to impose lender liability. The court noted that the lender was entitled to scrutinize the borrower's operations, and the exercise of the lender's contractual rights does not necessarily support a claim of undue or unfair control.

Controlling Collateral

Lenders also have to be extremely cautious when dealing with collateral. Upon taking physical

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or constructive control of the collateral, the lender exposes itself to "ownership" liability should there be physical damage, personal injury or environmental liability.

In *State ex rel. Cordray v. Estate of Roberts*, 188 Ohio App.3d 306, 935 N.E.2d 450 (2010), the Ohio Court of Appeals reversed the trial court's entry of summary judgment in favor of the lender, where issues of fact remained as to whether the bank properly disposed of collateral in the form of chemical drums, and whether the bank should be responsible for permitting its real estate collateral to deteriorate. After it took possession of the property, the bank sold some of the equipment collateral and drums containing chemicals, paint and stain. The bank then purchased the property at its foreclosure sale, only to later move to vacate the sale on the grounds that the building contained numerous defects not known, including a serious black mold contamination. The court refused to absolve the bank of liability, finding that issues of fact existed as to the bank's responsibility for the environmental damages, given that the bank had exercised control over the property. Thus, lenders that fail to consider the hidden dangers of assuming control over real estate collateral could be assuming material liabilities and responsibilities.

In *Melamed v. Lake County National Bank*, 727 F.2d 1399 (6th Cir. 1984), the plaintiff trustee argued that the creditor bank received a fraudulent transfer from the debtor company and that the creditor bank tortiously interfered with the debtor company. The creditor bank claimed that "…it did nothing more than any lienor would do to protect its interest and that its actions were designed to help all creditors of [the debtor company], that this was a typical 'workout' situation." The court noted that there was evidence that the creditor bank required the president to take a fifty percent reduction in salary, that it had required the company to replace its accountant with one chosen by the bank and that the bank's approval was required for all payments by the company. The president of the debtor company "testified that the [b]ank's supervision of all payments created 'very severe problems in operating the company,' [and] that he was forced to operate without knowing what money was available since the [b]ank would not tell him …." Additionally, the creditor bank apparently imposed a thirteen-point program on the debtor company that was designed to "help salvage whatever [was] possible" from the situation. The Sixth Circuit found this evidence to be sufficient to allow the claim of tortious interference to go to a jury. Thus, while the court dismissed the fraudulent transfer claim, it remanded the action to determine whether or not to proceed with a new trial on the tortious interference claim based on the bank's conduct with respect to the company's operations. Many cases involving allegations of undue control over collateral will turn on the frequency, substance and context of communications, suggestions and directives emanating from the lender.

Appointing Board Members and Affecting Corporate Decisions

Lending facilities often confer on the lender the right to appoint board members and to assume control over the business through informal means, insert restructuring officers, or exercise other receivership-type remedies. Generally, the exercise of such contractual rights will not form the basis for independent liability. This very situation was addressed in *Roswell Capital Partners LLC v. Alternative Construction Technologies*, 638 F. Supp. 2d 360, 370 (S.D.N.Y. 2009). The court found that the lender's appointment of two members to the board of directors was not an

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exercise of control, did not create a fiduciary duty, and did not support a claim of breach of the duty of good faith and fair dealing as it was merely an exercise of the plaintiff's contractual rights. This does not mean that lenders then have the ability to influence such board members, and any attempt to influence or sway board matters could expose the lender to a liability claim.

Another remedy that often ensnares lenders in collateral litigation involves taking action against pledged stock of the borrower. Lenders generally are permitted to exercise such remedies only upon an event of default, and courts generally enforce such contractual rights. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991), for example, the court dismissed claims challenging the creditor's exercise of ownership over the stock of the company and the removal of the adverse board members.

Lenders at times hold equity as well as debt, which provides adverse parties the right to claim that the lender exercised control and influence over the company operations to protect its equity and debt. In a long-standing decision from the Eighth Circuit, *Chicago Mill & Lumber Co. v. Boatmen's Bank*, 234 F. 41 (8th Cir. 1916), the lender avoided liability on an instrumentality theory when it was alleged to have controlled the company and its management. The primary evidence offered to prove this level of control was that the lender had arranged for an employee to become president of the borrower, in order to protect the lender's interests. The court found the lender's actions to be a legitimate business practice, in line with a creditor's need to maintain oversight of the borrower. The lender's control therefore did not impose liability based on the instrumentality theory. This practice, though, has significant risk, and counsel should therefore appropriately advise the lender as to how best to proceed.

Where the lender imposes its own management team and nearly bankrupts the company, it likely is inviting the borrower and guarantors to cry foul. This occurred in *State National Bank v. Farah Manufacturing Co.*, 678 S.W.2d 661 (Tex. App. 1984), in which the evidence supported the jury's findings that the lender engaged in fraud, duress, and interference resulting in loss to the borrower. The court found substantial evidence that acts of the lender resulted in fraud, duress, and interference, which proximately caused significant losses to the borrower.

Ending the Relationship

Claims grounded in a lender's control often surface when the relationship between lender and borrower deteriorates. The most common source of conflict is the appointment of a restructuring officer or consultant. Given the decline of the business and the introduction of an outsider reviewing and challenging decisions, tensions are typically heightened and disputes can easily arise. In *FAMM Steel, Inc. v. Sovereign Bank* (cited above), the court addressed this very issue and dismissed the borrower's claims that Sovereign accepted fiduciary responsibilities by insisting that restructuring consultants be hired and that they had acted under the bank's direction. The court noted that the lender's actions took place while FAMM was in default and that the majority of the allegations were based on the lender's failure to take actions that the loan agreement did not require.

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Borrowers have attempted to impose liability on lenders for adopting firm negotiating positions with respect to the credit and collateral. Many courts have looked unfavorably on lenders that adopt such positions in the absence of a deterioration in the credit or collateral and prior to an event of default. On the other hand, if the lender has the right to adopt a hard-line position and can substantiate a legitimate and reasonable rationale, the courts likely will side with the lender. For example, in *Federal Deposit Insurance Corp. v. LeBlanc*, 85 F.3d 815, 822 (1st Cir. 1996), the First Circuit, applying Massachusetts law, found that the bank did not act inappropriately by engaging in "hard-nosed" dealings with a borrower where it was undisputed that the bank did not take any of the adverse actions before the borrower defaulted. The implied covenant of good faith and fair dealing does require, however, that the lender exercise its rights and discretion reasonably, and any such instances should be examined carefully to ascertain whether or not such exercise was justified. *See BA Mortg. & Int'l Realty Corp. v. Am. Nat'l Bank & Tr. Co.*, 706 F. Supp. 1364, 1373 (N.D. Ill. 1989) (the implied covenant requires a bank to exercise its discretion reasonably).

Conclusion

Claims based on control issues are typically fact-intensive and could be the source of expensive and expansive discovery pursuits. Lender's counsel should strive to advise clients prospectively as to how best to navigate through troubled credit scenarios to mitigate exposure. Borrower's counsel should explore whether the lender may have overstepped the imaginary line and exercised an unreasonable level of control to warrant a court challenge. Both sides of the dispute, however, should be cautioned that commercial lending disputes can be complex and expensive and that all efforts should be exhaustively explored before resorting to litigation.

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