

Avoiding Lender Liability

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SBA West Virginia District Office

Presented By:
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SBA West Virginia District Office
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Instructor

Ethan W. Smith

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Ethan's areas of practice focus on government guaranteed lending, commercial lending, banking, real estate and commercial law. Ethan has closed thousands of government guaranteed loans nationwide and has assisted hundreds of lenders recover millions of dollars of impaired SBA guarantees.

Starfield & Smith, P.C. is a boutique law firm specializing in all aspects of SBA-guaranteed lending, from origination through liquidation, for lenders nationwide. Starfield & Smith closes over \$800 million of SBA guaranteed loans for its lender clients every year. For more information about Starfield & Smith, visit www.starfieldsmith.com .

Presented By: Ethan W. Smith, Esq.

We would like to thank Ethan Smith for his time and providing information regarding his experience in lending and working on SBA loans from his perspective.

All opinions, conclusions, and/or recommendations expressed herein are those of the presenter and do not necessarily reflect the views of the SBA.

Agenda

Avoiding Lender Liability:

- Origination
- Servicing/Liquidation

Risks/Rewards of SBA Lending

Rewards:

- Revenue
- Risk Mitigation
- Expanded credit box
- Increased lending limits

Risks:

- Loss of guaranty
- Litigation
- Increased losses
- **Lender Liability**

Origination



Origination

Communication

- People
- Documents
- Issues



Origination

People:

- Loan officers
- Brokers
- Other Lender employees

People

Loan officers (BDO's)

- How compensated?
- Incentives?
- Volume?
- Performance?
- Training?
- Hiring?
- To whom is a fiduciary duty owed?



People (Continued)

Brokers (Referral Agents)

- Vetting process?
- Track Record?
- What is the broker's role?
 - Facilitator or gatekeeper?
- Relationship with loan officer
 - Conflict of interest?
- Independent verification of info. received from Broker

People (Continued)

Communications

- Is a lender responsible for its LO's representations
 - written or oral?
- Can a lender be responsible for a broker's representations and actions? How?
- Who does Broker represent?

People (Continued)

Representations by LO and BDO (oral or written)

- Fees and costs
- Rate
- Collateral required
- Guarantors needed
- Statements about competitors and their products

People (Continued)

Communication

- What information is requested?
- How do lenders insure accuracy?
- What representations do the BDOs make about the lender, conventional loans and SBA loans?
 - Process?
 - Options?

Documents

Commitment Letter

Term Sheet

Email

Any written (or oral?)
communication

Lender Liability Issues

- Breach of contract
- Fraud
- Interference
- Negligent misrepresentation
- Breach of implied duty of good faith
- Breach of fiduciary duty
- Discrimination

Breach of Contract

Commitment Letter (CL)

- CL is a **contract** the purpose of which is to set forth terms of loan
- Lender's failure to abide by the contract may damage borrower and give rise to lender liability

Breach of Contract

Commitment Letter

- “Obligation” to lend (conditional or unconditional)
- should include all material conditions with appropriate carve outs, exit clauses and disclaimers (material adverse changes, compliance with all SBA reg’s., etc.)

Breach of Contract

- Examples:
 - Wrongfully refusing to honor the loan commitment – Ever happen? Why?
 - Refusing to honor alleged “side deal” between parties (which is known to BDO)
 - Failing to fund, finance or renew a loan
 - Failing to honor agreed-upon modification
 - Expiration – refusal to extend

Interference

- Deal structure
 - Stock purchase/Asset purchase
- Employment Contracts
- Issuing a CL without a bona fide intent to close
 - Get the deal “off the street”

Damages?

Negligent Misrepresentation

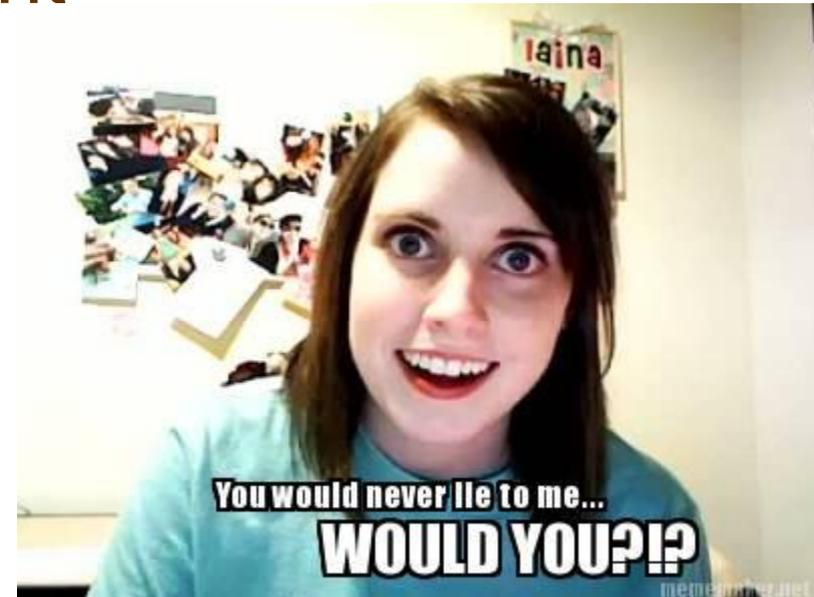
Lender misrepresents material fact under circumstances in which it should have known it was false; intent to induce another to act causing injury to borrower

Example:

- BDO learns that appraisal and environmental reports were improperly ordered (late and at wrong address), but assures borrower that loan can be closed within 30 days. Loan does not close within 30 days, as the reports are still not available.
- Lender misrepresented loan status by failing to acknowledge mistake and represent a speedy closing was possible
- Lender's action in mishandling the loan caused sale contract to expire
- Any other lender liability issues? Risks for Lender? Actual and consequential damages? Lapse of contract? Increased price? Increased costs? Legal fees?

Implied Duty of Good Faith

Every contract imposes a duty of G/F and fair dealing; and neither lender nor borrower may do anything to deprive the other of the benefits of the agreement



Implied Duty of Good Faith

Example #1:

- Lender insists that it cannot close the loan because the 4 *optional* franchise conditions cannot be met and because a landlord's consent cannot be obtained (even though there is no liquidation value in the business assets)
- Abuse of discretionary provisions (consents and approvals) in loan documents
- Remedies? Retention of deposit? Borrower remedy for breach? Actual and consequential damages?

Implied Duty of Good Faith

Example #2:

- Lender has total control over disbursements and after an argument with borrower, arbitrarily refuses to advance additional funds needed for renovations
- When should a lender refuse to advance additional funds?
- Under what circumstances would a refusal be proper? Improper?
- How can lender mitigate the risk?

Breach of Fiduciary Duty

Fiduciary: a person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the **trust** and **confidence** involved in it and the **scrupulous good faith and candor** which it requires. Thus, a person is a fiduciary who is invested with rights and powers to be **exercised for the benefit of another person**

Fiduciary Duty: When one party must act for another. They are entrusted with the care of property or funds.

Breach of Fiduciary Duty

General rule: debtor/creditor is not a fiduciary relationship.

Fiduciary duties may be created if dependency/control changes relationship

Under such circumstance, lender may owe a fiduciary duty to borrower (i.e., the borrower should be able to trust and rely upon the representations made by lender's employees). This means, in part, that the lender must treat borrower fairly, and not exert excessive control

Example:

Lender provides extra services

- Lender acts as financial advisor on business decisions (deal structure and tax advice) to unrepresented borrower
- Lender drafts legal documents for borrower (lease, operating agreement, etc.)
- Lender controls decision-making process (advises borrower on when and how to purchase equipment and inventory for the business)

Breach of Fiduciary Duty

- Examples:
 - OC as co-borrower or guarantor
 - Equity injection from 401(K) (Peek)
 - Stock purchase/redemption vs. asset purchase
- How to mitigate or eliminate these risks?
- Does lender bear any responsibility?
- Liability for unauthorized practice of law?



Duty of Confidentiality

What duties are owed to borrower at the inception of any loan which must remain confidential?

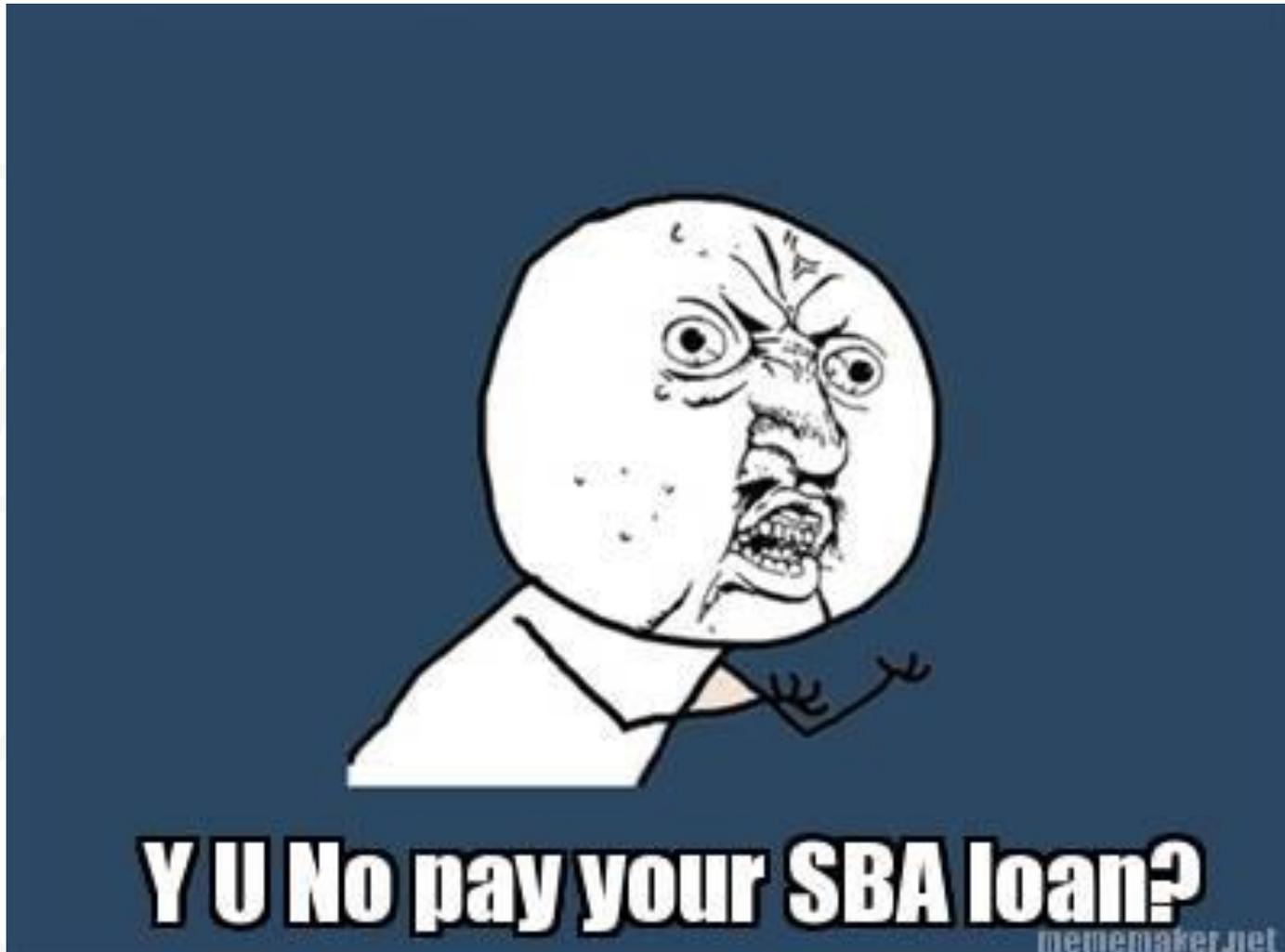
How does a lender insure that confidentiality is maintained?

What happens to attorney/client privilege if LO attaches “confidential” email from counsel to 3/P?

Examples: Criminal history, alien status, social security number, driver’s license; tax returns

- Liability for lender? Danger? [Risk of sharing information about borrower or its customers to competitor can expose lenders to liability]

Servicing and Liquidation



Loan Modifications

Examples include: increases in loan amounts, changes in loan terms, construction problems, failure to provide financial information and changes in term of loan

- Temporary or permanent?
- Need to avoid novation (substitution of new contract for old one whereby new agreement extinguishes rights under former agreement)
 - How does a lender avoid novation?
- Loan deferments: Other than a one-time 3 month deferment, what risks do lenders run by offering more? May lender be “estopped” from declining a request for deferment if its LO has promised one?

Insurance Issues

Under what circumstances should lenders force place insurance?

Under what circumstances should a lender not force place insurance?

Can placement/non-placement of insurance give rise to liability?

What information should lender disclose?

Construction Loans

- Lender assumes responsibility or right to disburse proceeds to parties other than borrower (should lender disburse proceeds to borrower other than w/c?)
- Lender is apprised of construction deficiencies and does nothing
- Lender is advised by borrower to withhold additional disbursements (or to pay subcontractors directly)
- Lender disregards borrower's complaints and continues to disburse proceeds without a bona fide attempt to investigate the truth of the complaints

Workouts

1. Risk to lender if it artificially prolongs an insolvent company's existence, and these actions jeopardize borrower's ability to satisfy claims of other creditors because of
 - an increase in debt; or
 - reduction in available assets
2. "Artificially" prolonging a debtor's existence is commonly done by forcing debtor to stretch trade or grow trade debt to keep debtor open long enough for borrower to collect A/R for SBA lender's benefit
3. Use of "Pre-Negotiation Letters"
4. Does the covenant of good faith impose a duty to forbear?

Liquidation

Placing a defaulting loan into liquidation status and accelerating indebtedness must be based on a “material” default. What does this mean? Covenant of Good Faith?

Should a lender become involved in the day-to-day management and operations of the business?

During work out, should a lender control the borrower’s assets, stock and management?

- Would such actions create a fiduciary relationship?
- If a lender takes over the business’ operations,
- may it expose itself to tax liability?



Summary

Integrity counts – make it part of your entire institution’s mission. Never stretch the truth in answering inquiries.

When unsure, ask and always document

Honor commitments to borrowers: never make representations inconsistent with the commitment.

If providing advice to a borrower, suggest – in writing - that borrower’s counsel and other advisors be consulted

On delicate communications over the phone, have at least 2 people on the call

Other delicate communications should be directed to counsel and oral communications should be timely documented

Summary

Avoid involvement in managing borrower's business

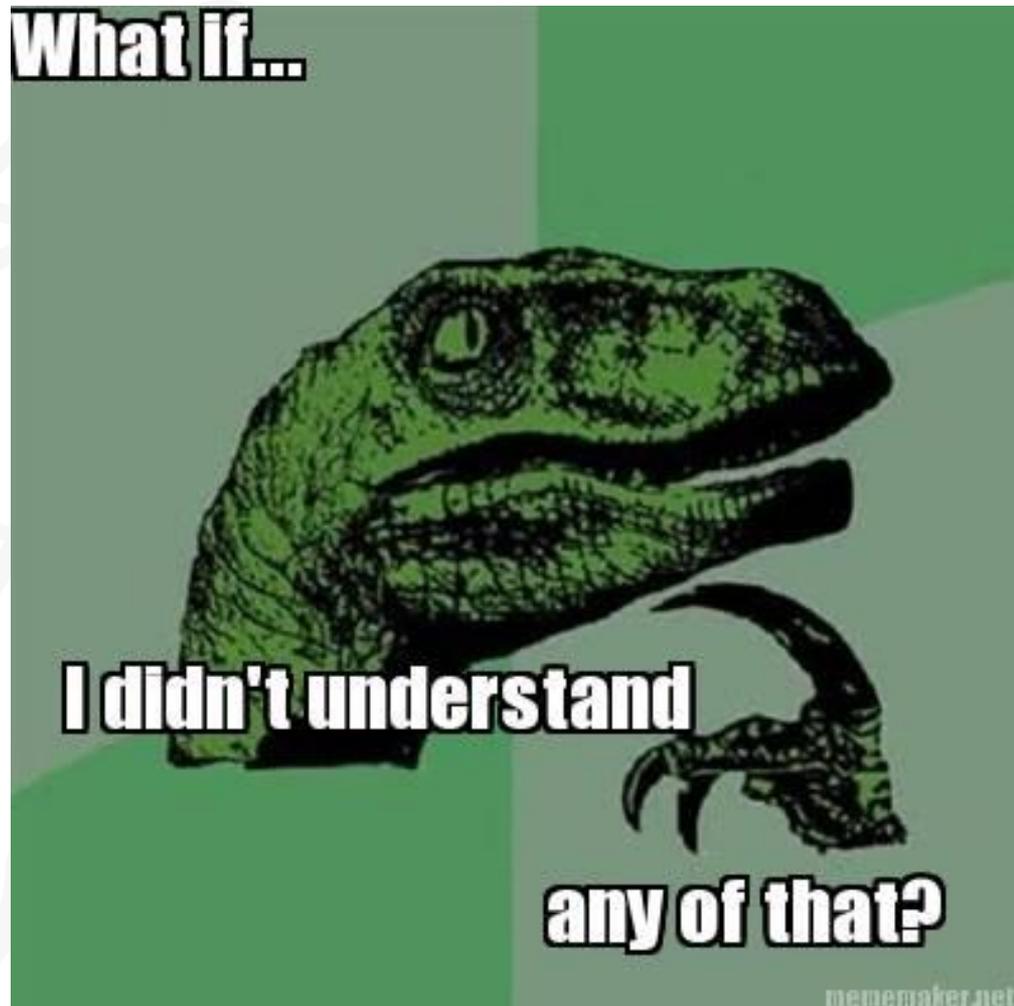
All written memos to file should be objective, unemotional and accurate

Negotiations handled appropriately and in good faith

When considering suing on a deficiency, always consider that a counterclaim could be far more expensive to defend

Treat borrowers with respect

Questions



Thank you!

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Or visit the SBA web site to find your local
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