Lender liability

What you need to know when you enter into a borrowing agreement

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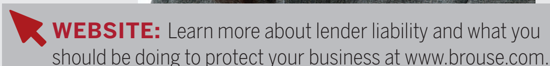

WEBSITE: Learn more about lender liability and what you should be doing to protect your business at www.brouse.com.

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Lender liability is a general term that encompasses a number of claims that can be asserted by a borrower against its lender. Lender liability actions tend to gain prominence during economic downturns.

"As businesses and real estate developments suffer in recessionary times, lender liability actions have historically tended to increase in number," says Suzana K. Koch, attorney at law at Brouse McDowell. "The types of legal claims filed under 'lender liability' can arise out of common law or statutory provisions."

The Uniform Commercial Code (UCC) imposes an implied duty of good faith on the lender-borrower relationship and a breach of duty can be a type of lender liability claim. Good faith is defined by the UCC as "honesty in fact and the observance of reasonable commercial standards of fair dealing."

Each party is required to sign a contract to act in such a way that would not deprive any other party of the benefits of the contract. Although this is the standard for commercial loan agreements, the reality is not always so straightforward.

Smart Business spoke with Koch about lender liability and the importance of knowing the details of the agreements you sign.

How can a borrower's financial circumstances dictate lender behavior?

If a borrower finds itself in financial trouble, the lender may seek to protect its assets and lower its risks by limiting borrowing capacity. This can, in turn, compromise the viability of a borrower's business. This type of lender behavior may lead to lender liability if the lender does not act in good faith.

Over the past several decades, courts have increasingly expanded the standard by which good faith is measured for lender liability claims, and good faith theories have been applied to every stage of the lending process.

One such example involves line-of-credit cases in which a lender, with the ability to exercise complete control over the borrower's business or cash flow, begins to restrict the credit line. When a borrower enters into an agreement with a lender to borrow only from that lender, there is an imbalance of power between the two.

If a borrower is financially distressed, drawing on the credit line may become the borrower's lifeline. The lender may be reluctant to advance cash to the borrower because of the borrower's financial troubles, but the lender's ability to control how much of an advance the borrower may receive can negate the purpose of the open line of credit.

How much responsibility does a lender have to honor a borrower's request?

While the traditional view taken by courts is that a line of credit does not obligate a lender to fund every request, the seminal case of K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) challenged this rule when a lender's refusal to advance on a line of credit ultimately led to the collapse of the borrower's business.

The loan agreement limited the borrower to only one lender, and the court held that good faith requires the lender to give the borrower sufficient notice to obtain alternative financing. Although this case has been heavily cited and distinguished across the country, the ruling in K.M.C. changed interactions between lenders and borrowers, and it continues to provide guidance for future interactions.

How can I protect my business and myself?

Lender liability claims are very fact-specific, so there has not been a bright line rule established. It is important, though, for commercial borrowers to maintain a close watch on lender activity and be keenly aware of the terms and conditions of their loan agreements.

Not all lender behavior rises to the level of bad faith, especially if notice is provided to the borrower.

Nevertheless, a borrower should be alert if a loan commitment or side deal is not honored, if its lender refuses to renew a loan or threatens enforcement action when it had previously agreed to forgo such action or if its lender interferes with day-to-day management. Lenders should be aware of the consequences to the borrower of their actions, so as to avoid liability for lack of good and fair dealing. ●

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