

Expanding Scope of Lender Liability

Presented by

James H. Moore, III

EXPANDING SCOPE OF LENDER LIABILITY

I. Corporate Environment has Expanded Lenders= Exposure:

With mounting concern in recent years over corporate governance and in an effort by those aggrieved by corporate misconduct to find a source of compensation for their losses, theories of lender liability relating to corporate wrongdoing, which was allegedly aided by lenders, have been expanding.

- A. Recent cases illustrate potential liability for lenders who extend credit to high risk debtors.
- B. Lenders may also be at risk where they obtain knowledge about a debtor=s misdeeds through due diligence, but continue to finance the debtor=s enterprise.
- C. Failing to put an ailing borrower out of its misery may also lead to liability.
- D. Although none of these creative theories have been approved by courts in Georgia, or even in the Southeast, they indicate the direction of recent decisions in other jurisdictions and represent legal principles with which lenders should become familiar.

II. Aiding and Abetting Tortious Conduct by Borrowers.

- A. In the case of *In re First Alliance Mortgage Company*, a Federal District Court decision from California decided in 2002, the Court allowed an allegation that a lender had aided and abetted improper conduct by a corporate borrower to lead not only to potential tort liability for the lender, but also equitable subordination of the lender=s claim in bankruptcy.
- B. In that case, First Alliance was in the business of sub-prime mortgage lending. First Alliance, which ultimately filed Chapter 11, allegedly engaged in deceptive and illegal practices in violation of consumer protection laws. The plaintiffs alleged that First Alliance=s primary

lender was liable for aiding and abetting that wrongful conduct because of credit facilities which it provided which allowed First Alliance to make loans.

- C. The aiding and abetting claim arose out of the allegation that First Alliance=s lender intentionally participated in its wrongful conduct by gaining knowledge, through the due diligence process, of that conduct and failing to do anything to prevent the defrauding of consumers.
 - D. Because the extension of credit by the lender made First Alliance=s allegedly fraudulent practices possible, the lender was seen as possibly providing Asubstantial assistance@ and thereby abetting the wrongful conduct by First Alliance.
 - E. In this case, the mere act of extending credit rendered the lender potentially liable for the debtor=s alleged fraud because of the knowledge of the borrower=s conduct gained by the lender through its own due diligence.
 - F. Moreover, not only was the lender possibly Aon the hook@ for the debtor=s wrongful lending conduct, it also was at risk of having its claim equitably subordinated to other creditors in the Chapter 11 because of the lender=s alleged participation in the debtor=s wrongful conduct, which had the impact of defrauding other creditors.
 - G. This case was of further interest because only bankruptcy trustees are allowed to assert equitable subordination claims. In this case, a group of individuals claiming to have been defrauded by First Alliance=s practices were the plaintiffs. Despite the fact they were individual creditors, and not in the position of a trustee, they were still allowed to assert the equitable subordination claim.
- III. Liability for Tort of ADeepening Insolvency@.
- A. Lenders in several jurisdictions (although not Georgia) have been held accountable for a tort of Adeepening insolvency@ - based on a plaintiff=s theory that a lender=s loan permitted a debtor to fraudulently continue its business, in ever-increasingly insolvency, to the detriment of creditors.
 - B. In the case of *In re Excide Technologies, Inc.*, 239 BR 732 (D.Del.2003), a tort claim was allowed against the creditor based on a claim of Adeepening insolvency@.
 - C. In the Excide case, a lender had made a further loan of \$250,000,000.00 to

Excide, to allow them to purchase a competitor and remain in business for an additional two (2) years.

- D. The plaintiffs contended that the additional loan gave the lender substantial control over the debtor and resulted in the loss of equity by creditors.
 - E. Thus, where there were allegations that the lender had exercised undue control after making additional loans to a debtor, which prolonged the debtor=s business existence to the detriment of creditors, a cause of action for Adeepening insolvency@ was found to lie.
 - F. A defense available to creditors in response to a Adeepening insolvency@ claim is the doctrine of *in pari delicto*. This doctrine says that a plaintiff-borrower may not assert a claim against the defendant-lender if the plaintiff-borrower bears fault for the claim or, in other words, a party is barred from recovering damages if the party=s losses are substantially caused by illegal or fraudulent activities of that party.
 - G. In the Excide case, the plaintiff=s allegations with regard to Adeepening insolvency@ were allowed to stand, but the bank was also allowed to assert the affirmative defense of *in pari delicto*, to demonstrate that the losses suffered were the responsibility of Excide, and not the lender.
 - H. The watchword here is caution in any circumstance where credit is extended to a financially-struggling entity. Concerns from some years ago about the exertion of excess control resulting in lender liability still exist. In these newer cases, however, the exertion of excess control by the lender is not the basis of liability, but rather avoidance supporting the allegation that actions of the lender Adeepened@ the level of the borrower=s insolvency and thereby prejudicial creditors.
- IV. Liability for Aiding and Abetting Fraud.
- A. Courts also appear to be giving renewed attention to allegations that lenders aided and abetted fraud allegedly carried out by a failing corporate enterprise.
 - B. In the case of *In re Sharp Int=l. Corporation* (a 2003 Bankruptcy Court decision from the State of New York), a Court refused to dismiss an allegation that a lender had aided and abetted fraud based upon pre-existing knowledge of the debtor corporation=s wrongdoings.
 - C. Sharp was a closely-held corporation and its former owners were accused of fraud against the company and its creditors by inflating the company=s financials and then utilizing large amounts of cash raised as a result for

purposes unrelated to the corporation.

- D. The plaintiff alleged that lenders of Sharp had reason to know of the wrongful conduct of the owners of the closely-held company, but approved a line of credit in any event which facilitated the fraud.
 - E. In that case, the lender first became suspicious and launched an investigation, but dropped the investigation when Sharp obtained new financing, from other investors who were unaware of the wrongful conduct, and used that financing to pay off most of the indebtedness owing to the lender.
 - F. The investors who had provided the funds used to pay off the lender alleged that the lender aided and abetted fraud because of its superior knowledge of the borrower=s circumstance.
 - G. The Court found that sufficient facts were alleged that the lender actually knew of the company=s fraudulent conduct to allow it to refuse to dismiss the claim against the bank.
 - H. Word to the wise here - don=t attempt to shift the risk of a bad loan situation to a third party where your institution may have superior knowledge of the debtor=s true condition and may be in a situation where a duty to disclose may be imported.
- V. What do These Types of Claims Indicate for You as a Georgia Lender?
- A. No claims of this type have yet to be asserted in the State of Georgia. However, theories of liability from the West coast and Northeast eventually Afilter down@ to the rest of the country and these novel claims probably indicate the wave of the future.
 - B. Renewed diligence for lender liability-type concerns is merited, given the present mind set to try to find someone to blame when investors have substantial losses resulting from a business failure.
 - C. Be on your toes when extending or renewing credit to financially-troubled businesses, especially those which have outside shareholders. Because of your perceived Adeep pockets@ an attempt may be undertaken to blame losses on you because your institution in some way assisted in perpetrating a fraud or in making a bad financial situation worse.