What Lawyers and FAs Must Know to Represent Secured Creditors Successfully

American Bankruptcy Institute

2017 Annual Spring Meeting

April 22, 2017

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Anticipating Lender Liability Claims—Predicting Punches[1]

"An ounce of prevention is worth a pound of cure."
—Benjamin Franklin

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The 2007 financial crisis has led to a proliferation of "lender-liability" suits as cash-strapped debtors and out of the money constituents seek deep pockets from which to recover funds. Whether it be defending lawsuits based on malfeasance or nonfeasance or defending the validity, extent, and priority of its liens, lenders are subject to attack at almost any juncture and from all sides. Even with the end of the financial crisis, this trend continues as retail giants fall and debtors turn to quick 363 sales with increasing frequency. In light of this distressed landscape, lenders should pay particular attention to potential pitfalls as they approach distressed borrower relationships.

The typical claims raised by borrowers include one or a combination of the following: a breach of the covenant of good faith and fair dealing or a breach of fiduciary duty arising from a "special relationship" between the borrower and the lender and/or the lender's control of the borrower's operations.[3] A borrower may affirmatively assert lender liability claims as a plaintiff or assert them as counterclaims as a defendant in a lender-initiated foreclosure action or lawsuit.[4] In bankruptcy, lenders face additional causes of action derived from the Bankruptcy Code itself or claims resulting from the Bankruptcy Court's equitable jurisdiction. This article focuses on several of the most common bases of lender liability in distressed financial situations and is designed to provide a quick reference guide to help frame distressed loan strategies.

Covenant of Good Faith and Fair Dealing

Because "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement,"[5] lenders are likely to face allegations of breaches of these covenants in the context of a lender liability suit. Broadly speaking, the covenant of good faith and fair dealing requires a party to a contract to deal with the other honestly, fairly, and in good

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[2] I gratefully acknowledge the research support provided by Anna Haugen and Kathryn Z. Keane in preparing this article.

[3] Michelle Z. McDonald, *The Complicated World of Lender Liability*, 40-APR COLO. LAW 13, 14 (Apr. 2011).

[4] *Id.*

[5] Restatement (Second) of Contracts § 205 (1981).

faith, so as not to deprive the other party of the benefits of their contract.[6] The Uniform Commercial Code, which can govern lending relationships in the context of sales transactions, secured transactions, promissory notes, and negotiable instruments, defines "good faith" as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[7] The covenant of good faith and fair dealing applies when the performance of a specific contract term permits either party to exercise discretion.[8] When a contract is silent, the principles of good faith fill the gap.

Nevertheless, the covenant of good faith and fair dealing cannot be applied in a manner that contradicts the express terms or conditions of a contract.[9] Allegations of bad faith frequently focus upon lender action taken shortly before or after a default under the loan documents or a failed attempt to refinance or restructure the loan. Generally, a lender does not have an obligation to assist a borrower in restructuring an existing loan unless there is an express provision in the loan documents to the contrary.[10] Accordingly, a mere failure to assist in refinancing is not sufficient. But, lender liability issues may arise when the loan documents give

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[6] Comment d to § 205 states as follows:

> Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify
> terms, and interference with or failure to cooperate in the other party's performance.

[7] U.C.C. § 1-201(b)(20) (amended 2003). *See, e.g.*, *Precision Pine & Timber, Inc. v. United States*, 596 F.3d 817, 820 n.1 (Fed. Cir. 2010) ("Both the duty not to hinder and the duty to cooperate are aspects of the implied duty of good faith and fair dealing."). *Essex Electro Eng'rs, Inc. v. Danzig*, 224 F.3d 1283, 1291 (Fed. Cir. 2000) ("Every contract, as an aspect of the duty of good faith and fair dealing, imposes an implied obligation 'that neither party will do anything that will hinder or delay the other party in performance of the contract.'").

[8] McDonald, 40-APR COLO. LAW at 14.

[9] *See Metcalf Constr. Co. v. United States*, 742 F.3d 984, 991 (Fed. Cir. 2014) ("The implied duty of good faith and fair dealing is limited by the original bargain: it prevents a party's acts or omissions that, though not proscribed by the contract expressly, are inconsistent with the contract's purpose and deprive the other party of the contemplated value."); *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188, 1195 (10th Cir. 2004) ("The implied covenant cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract.) (internal quotation marks omitted). A lender generally does not breach the covenant of good faith and fair dealing unless its conduct is dishonest, intentionally deceptive, or constitutes an outrageous behavior. *Mora v. US Bank*, No. cv-15-2436, 2015 WL 4537218, at *4 (C.D. Cal. July 27, 2015) (dismissing claim for breach of the implied covenant of good faith and fair dealing where plaintiffs had "not alleged that they fulfilled their obligations under the mortgage loan contract," alleging instead that they could not make scheduled payments, declared bankruptcy to avoid foreclosure, and further stopped performing when "it was clear that they were excused from further performance by acts of discrimination against them").

[10] Indeed, acting consistent with its rights under a loan agreement is generally insufficient to support a finding that a lender breached the implied covenant of good faith and fair dealing. *See Lehman Bros. Holdings Inc. v. JPMorgan Chase Bank, N.A. (In re Lehman Bros. Holdings, Inc.)*, 541 B.R. 551, 568–70 (S.D.N.Y. 2015) ("Put simply, a party does not breach an agreement by behaving as the instrument permitted.").

the lender approval or consent rights over borrower's actions.[11] To protect from later attacks on its business judgment, a lender's actions should be based on well-documented and commercially reasonable grounds.[12]

In light of increasing scrutiny from creditor and other groups, lenders should also take precautionary steps when approaching a distressed lending relationship. While every situation presents its own unique challenges, precautionary steps may include, but not be limited to, the following: 1) providing the borrower with reasonable written notice before taking material actions even if written notice is not required by the loan documents; 2) providing the borrower with an opportunity to cure nonmonetary defaults before pursuing any remedies; 3) considering reasonable proposals made by a borrower while negotiating a restructuring or modification of the loan and responding to such proposals within a reasonable time; 4) promptly addressing borrower requests and documenting lender responses, whatever that response may be; 5) demonstrating adequate consideration for other aspects of the loan, such as reviewing borrower's appraisals or independently analyzing the value of the collateral; 6) avoiding the exercise of harsh remedies for technical, nonmonetary defaults; and 7) expediently commencing a foreclosure following a default.[13] Initial communications should clearly state that the lender is not waiving any right or remedy by delaying immediate enforcement of its contractual rights (such as enforcing default interest, sweeping accounts, or foreclosing). Importantly, a lender should reinforce that no discussions are final or binding until they are in writing and signed by both parties.

Further, as part of any forbearance or workout agreement, a lender should obtain a general release from its borrower of known and unknown claims through the date of execution. Workout or forbearance agreements also present good opportunities to fix any defects in the original loan documentation—tighten liquidity requirements, obtain additional collateral, strengthen remedies upon default, provide for more frequent reporting, *etc*. Lenders should weigh the need for a release against the costs of potential borrower concessions. Legal and financial advisors can help determine and evaluate the impact of monetary and non-monetary concessions.

If a workout is not feasible, lenders should avoid any unreasonable delay in responding to borrower inquiries or proposals so as to avoid an impression that the loan could be restructured or that a borrower's proposal is being carefully considered. Moreover, taking extreme measures on technical defaults, especially on commercial loans, such as a failure to timely submit financial statements, are generally not received well by courts. Lastly, lenders should be wary of quickly

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[11] *See, e.g.*, *K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752, 759–60 (6th Cir. 1985).

[12] Business judgment also serves as a powerful defense to a later lawsuit.

[13] *Compare K.M.C. Co., Inc.*, 757 F.2d at 759–60 (awarding $7.5 million to a borrower when a lender breached a covenant of good faith by failing to give sufficient notice before refusing to advance funds up to the maximum limit of a revolving line of credit) *with Westinghouse Elec. Corp. v. McLean*, 938 F. Supp. 487, 494 (N.D. Ill. 1996) (finding lender not liable for failing to disburse additional funds to borrower because the credit agreement provided that disbursements of funds by lender would be discretionary).

altering their course of conduct with their borrowers unless warranted by the circumstances.[14] For instance, after an established pattern of ignoring defaults, a letter or communication demanding strict compliance with the terms of a loan document (especially non-material provisions) without providing, at a minimum, prior written notice or a very brief cure period may trigger liability.[15] At the end of the day, a lender should approach a distressed situation as it would any business relationship: with careful consideration of the pros and cons and clear and effective communication, keeping in mind the principles discussed herein.

Breach of Fiduciary Duties

Courts are reluctant to convert the lending relationship into a fiduciary one absent special circumstances.[16] Thus, generally a lender's duties to its borrower are delineated in the loan agreement and accompanying documents. However, when a lender possesses too much control over the borrower or the borrower relies on the lender's trust and confidence as a result of special circumstances, the borrower-lender relationship may be converted into a fiduciary one.[17] In those cases, the lender will owe the borrower duties greater than those set forth in the loan documents.

Certain actions, however, are normal course between a borrower and lender and will not result in the imposition of a fiduciary relationship. For example, in *FAMM Steel, Inc. v.*

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[14] *Sahadi v. Cont'l Ill. Nat'l Bank & Trust Co.*, 706 F.2d 193, 197 (7th Cir. 1983) (holding there was an issue of fact as to whether calling of a loan was made in good faith where, among other things, bank had "clear knowledge that [the borrower] had on hand in the Bank, and tendered, funds sufficient to satisfy the interest requirement; the Bank had previously accepted late payments in its course of dealings with [the borrower]; and there was evidence that calling a loan for such a brief delay [of less than one day] was without precedent in the banking community").

[15] *See, e.g.*, *Windsor Shirt Co. v. N.J. Nat'l Bank*, 793 F. Supp. 589 (E.D. Pa. 1992) (evidence sufficient to support cause of action against a lender where the lender routinely waived technical defaults, but demanded full payment one month before the due date), *aff'd*, 989 F.2d 490 (3d Cir. 1993).

[16] *Sallee v. Fort Knox Nat'l Bank, N.A. (In re Sallee)*, 286 F.3d 878, 893 (6th Cir. 2002) ("Except in special circumstances, a bank does not have a fiduciary relationship with its borrowers."); *Forsythe v. BancBoston Mortg. Corp.*, 135 F.3d 1069, 1077 (6th Cir. 1997) ("[T]he great weight of authority is that while the relationship between a mortgagor and mortgagee is often described as one of trust, technically it is not of a fiduciary character.") (alterations in original and internal quotation marks omitted). Indeed, as noted by the Third Circuit Court of Appeals, it "'would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table.'" *Paradise Hotel Corp. v. Bank of Nova Scotia*, 842 F.2d 47, 53 (3d Cir. 1988) (quoting *Weinberger v. Kendrick*, 698 F.2d 61, 79 (2d Cir. 1982), *cert denied*, 464 U.S. 818)); *see also Needham v. The Provident Bank*, 675 N.E.2d 514, 522 (finding no fiduciary relationship based on bank's advertisement as a "Partner in Business").

[17] *Compare Steelvest, Inc. v. Scansteel Serv. Ctr., Inc.*, 807 S.W.2d 476, 485 (Ky. 1991) (imposing fiduciary duty where bank used borrower's confidential information to assist one of borrower's competitors to generate new business for bank); *Broomfield v. Kosow*, 349 Mass. 749, 212 N.E.2d 556, 560 (Mass. 1965) ("[T]he plaintiff alone, by reposing trust and confidence in the defendant, cannot thereby transform a business relationship into one which is fiduciary in nature. The catalyst in such a change is the defendant's knowledge of the plaintiff's reliance upon him.") *with Cowan Bros. v. Am. State Bank*, 743 N.W.2d 411, 420–22 (S.D. 2007) (finding bank did not owe borrower a fiduciary duty when it allegedly engaged in malicious and oppressive conduct).

Sovereign Bank,[18] an institutional bank loaned money to a borrower to expand its steel fabrication operations. Due to unexpected circumstances, the borrower suffered operating losses resulting in financial difficulties, which ultimately led to default.[19] After the borrower defaulted, the lender requested that the borrower hire an outside turnaround consultant approved by the lender to monitor its operations, terminated automatic bank sweeps between the borrower's checking account and its line of credit without notifying the borrower, and failed to respond to various workout or refinancing proposals.[20] As a result, the borrower terminated operations, which resulted in a loss of more than $4 million.[21] The borrower later sued the lender alleging, among other things, that lender breached its fiduciary duty to the borrower because the lender directed the consultant to suspend the borrower's monthly financial reports.[22] The First Circuit rejected the borrower's arguments, holding that the lender's involvement in the borrower's affairs was not unusual in the context of a commercial loan and did not create a fiduciary relationship.[23]

Special Relationship/Control[24]

In certain, rare instances, courts have held lenders liable based upon the lender's special relationship with its borrower. The following factors may give rise to a "special relationship": 1) when a borrower is guided by the judgment or advice of the lender or is justified in believing that the lender will act in its interest; 2) when the lender has acquired influence over the borrower and has abused that influence; 3) when the parties have worked together toward a mutual goal for a long period of time; 4) when the lender knows or has reason to know that the borrower is placing its trust and confidence in the lender and is relying on the lender for advice; 5) when both parties understand that a special trust or confidence was created; and 6) when there is an allegation of dependency by the borrower and a voluntary assumption of a duty by the lender to advise, counsel, and protect the borrower.

To avoid "special relationship" issues lenders should not: 1) actively participate in the management of the borrower's business; 2) give business advice; 3) instruct the borrower about which trade creditors should and should not be paid; 4) make representations to the borrower's trade creditors that would induce them to extend additional unsecured credit; or 5) depart from

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[18] 571 F.3d 93 (1st Cir. 2009).

[19] *Id.* at 97.

[20] *Id.* at 97–99.

[21] *Id.* at 99.

[22] *Id.* at 99.

[23] *Id.* at 102.

[24] This concept of a special or insider-type relationship has also manifested itself in Bankruptcy Code specific causes of action. For example, in *Schubert v. Lucent Techs Inc. (In re Winstar Commc'ns, Inc.)*, 554 F.3d 382 (3d Cir. 2009), the Third Circuit expanded the definition of an "insider" under section 101(31) of the Bankruptcy Code to include a creditor with a "close relationship" with a debtor, and required the lender at issue to return $188 million in loan payments it had received from the debtor in the year prior to bankruptcy as a preferential transfer.

following their policies and procedures regarding disclosure of information to third parties. Lenders should also, within pertinent loan documents, include a clause disclaiming any partnership or co-venture relationship and expressly state that the lender has not accepted any position of trust or confidence.[25]

Moreover, to the extent that a lender exercises significant control over a borrower, the lender may subject itself to a finding of a fiduciary or other relationship. Unfortunately, there are no precise guidelines to avoid a finding that a lender impermissibly controlled the debtor's affairs. Thus, working with a troubled borrower involves a delicate balancing act to protect your investment while also minimizing litigation risk. If a lender secures its interests in accordance with the express terms of its loan documents, courts are reluctant to find that the lender controlled the debtor.[26] Permissible actions to secure collateral and protect rights include, but are not limited to: 1) active monitoring of a deteriorating situation; 2) protecting and disposing of collateral;[27] 3) establishing a lockbox for the collection of receivables; or 4) advancing funds for operating expenses pursuant to the disbursement schedule or terms of the loan. In contrast, the following actions may lead to finding of control (and ultimately a finding of liability) for a lender: 1) involving itself in the day-to-day management and operations of the borrower;[28] 2) compelling the borrower to engage in unusual transactions; 3) appointing or directing the employment of officers or directors; or 4) owning or controlling a significant amount of a borrower's voting stock or partnership voting rights.

Equitable Subordination

The doctrine of equitable subordination, codified in 11 U.S.C. § 510(c), provides creditors with a remedy for a lender that has acted in a manner that harms creditors. Specifically, when a lender is found to have acted wrongly, its claim can be subordinated to that of other

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[25] *See, e.g.*, *Alpine Bank v. Hubbell*, 555 F.3d 1097, 1111–12 (10th Cir. 2009) (finding that construction loan documents permitting a lender to oversee construction did not create additional responsibilities when the underlying loan documents expressly provided that lender had not accepted any position of trust or confidence); *FDIC v. L.L. Claycomb*, 945 F.2d 853, 859 (5th Cir. 1991) (stating that there was no special relationship where parties expressly disavowed the existence of any partnership and disclaimed any sharing of losses); *Torke v. FDIC*, 761 F. Supp. 754, 757 (D. Colo. 1991) (finding that no fiduciary relationship existed when a lender helped its borrower-developer select workers on the project, controlled the loan disbursements, required regular and frequent reports, and took an active interest in obtaining the required zoning on the property).

[26] *See, e.g.*, *Cossoff v. Rodman (In re W.T. Grant Co.)*, 699 F.2d 599, 609–10 (2d Cir. 1983) (noting that a lender was within its rights to enforce an agreement and was not in control of the borrower by "recoup[ing] the most amount of money as possible" and by closely monitoring the borrower).

[27] *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 948–50 (7th Cir.1989) (holding that that a bank was not a "controlling person" even though it directed the borrower to sell certain assets to meet its loan obligations).

[28] *See, e.g.*, *Paracor Fin., Inc. v. Gen. Elec. Capital Corp.*, 79 F.3d 878, 890 (9th Cir. 1996) (finding that lender that was supposed to receive a portion of debenture sale proceeds was not a controlling person, because it did not exercise day-to-day control over the company; the inquiry must focus on the "'management and policies' of the company and not on the discrete transactions") (citation omitted), *aff'd in part, rev'd in part on other grounds*, 96 F.3d 1151 (9th Cir. 1996).

secured creditors, or even below unsecured creditors.[29] When faced with claims for equitable subordination, bankruptcy courts consider whether the conduct of the lender in relation to other creditors is or was such that it would be unjust or unfair to permit the lender to share pro rata with other creditors of equal status notwithstanding the apparent legal validity of a particular claim.[30] Whether a court will order the equitable subordination of a lender's claim is a fact-specific determination and varies from case to case. Following the test articulated in *Benjamin v. Diamond (In re Mobile Steel Corp.)*,[31] or some derivation thereof, courts may equitably subordinate a claim if three conditions are satisfied: 1) a lender engaged in inequitable conduct; 2) the misconduct resulted in injury to other creditors or conferred an unfair advantage on the lender; and 3) equitable subordination is not inconsistent with the provisions of the Bankruptcy Code. Identifying inequitable conduct[32] is critical in equitable subordination cases. Inequitable conduct is commonly defined as: fraud, illegality, or breach of fiduciary duty; undercapitalization; or control or use of the debtor as an alter ego for the benefit of the claimant.[33] Inequitable conduct also includes lawful conduct that "shocks one's good conscience."[34]

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[29] Section 510(c) authorizes a bankruptcy court to, "under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest . . . ." 11 U.S.C. § 510(c).

[30] *Mishkin v. Siclari (In re Adler, Coleman Clearing Corp.)*, 277 B.R. 520, 563 (Bankr. S.D.N.Y. 2002).

[31] 563 F.2d 692, 699–70 (5th Cir. 1977).

[32] As courts of equity, bankruptcy courts have a variety of tools to punish perceived inequitable lender conduct in addition to equitable subordination. For example, inequitable conduct may also lead to limitation of a creditor's right to credit bid the full amount of its claim at a bankruptcy auction under section 363 of the Bankruptcy Code. *See generally In re Free Lance-Star Publ'g Co. of Fredericksburg, VA*, 512 B.R. 798 (Bankr. E.D. Va. 2014) (limiting secured creditor's credit bid by over half based upon a variety of factors, including 1) the secured creditor's less than fully secured status; 2) its "overly zealous" loan to own strategy; and 3) the negative impact of its misconduct on the auction process); *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014) (finding that "cause" existed under section 363(k) to limit secured creditor's right to credit bid where creditor had chilled the bidding process by inequitably pushing the debtor into bankruptcy so that it could short-circuit the bankruptcy process to purchase the debtor's assets).

Recently, however, a decision from the *Aéropastle* case follows more closely the pre-2014 case law on section 363(k), which defined "cause" to limit credit bid rights to situations involving egregious conduct (*i.e.*, collusion). After an eight day, 14 witness trial, Judge Lane rejected the debtors' attempts to limit credit bidding in reliance on *Free Lance-Star* and *Fisker*, among others, and ruled that the secured creditor group could credit bid up to the full amount of its $150 million pre-petition secured loan. *See generally In re Aéropastle, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2016).

[33] *Official Comm. of Unsecured Creditors of Lois/USA, Inc. v. Conseco Fin. Servicing Corp. (In re Lois/USA, Inc.)*, 264 B.R. 69, 134–35 (Bankr. S.D.N.Y. 2001).

[34] *In re Adler, Coleman Clearing Corp.*, 277 B.R. at 563; *Credit Suisse v. Official Comm. of Unsecured Creditors (In re Yellowstone Mountain Club, LLC)*, Adv. No. 09-00014, 2009 WL 3094930, at *8 (Bankr. D. Mont. May 12, 2009) (subordinating lenders' $232 million secured first lien position on a luxurious ski resort because lenders' commercial loans were so "overreaching and self-serving that they shocked the conscience of the Court"), *vacated by*, Case No. 08–61570–11–RBK, 2009 WL 10624435, at *1 (Bankr. D. Mont. June 29, 2009) (allowing lenders' claims and valuing collateral at $232 million).

Most commonly, courts subordinate liens if a lender maintains a high level of control over the debtor and there is evidence that transactions between the parties were not conducted at arm's length. There is no clear definition of what constitutes a creditor's control over its borrower.[35] In determining the issue of "control," courts consider a number of factors, including: 1) whether the lender exercises control over the borrower's voting stock; 2) whether the lender exercises managerial control, including personnel decisions and decisions as to which creditors should be paid; 3) whether the relationship between the borrower and lender was the result of an arms-length transaction; and 4) whether the lender is the debtor's sole source of credit.[36] To establish domination and control by a lender, the allegations must indicate something more than a monitoring of a debtor's operations and proffering advice to management, even where the lender threatens to withhold future loans should the advice not be taken.[37]

If however, the non-insider has not dominated or controlled the debtor to gain an unfair advantage, "the type of inequitable conduct that justifies subordination of a non-insider's claim is breach of an existing, legally recognized duty arising under contract, tort or other area of law."[38]

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[35] *Herzog v. Leighton Holdings, Ltd. (In re Kids Creek Partners, L.P.)*, 200 B.R. 996, 1015–16 (Bankr. N.D. Ill. 1996) (explaining the "two types of control: 'de jure' control and 'de facto' control" and reasoning that "a lender usurping the power of a debtor's directors and officers to make business decisions must also undertake the fiduciary obligation that the officers and directors owe the corporation and its creditors").

[36] A good example illustrating the type of the relationship between a creditor and a debtor that could could lead to equitable subordination is provided in the Third Circuit's opinion in *Winstar*, 554 F.3d 382 (3d Cir. 2009), discussed, *supra*. In *Winstar*, the Third Circuit affirmed the bankruptcy court's decision to subordinate the creditor's claim to the claims of the debtor's other creditors. *Id.* at 414. Prior to filing for bankruptcy, the debtor, a local and long distance telecommunication services company, entered into a "strategic partnership" through which the creditor provided substantial financing and the debtor was obligated to purchase much of its equipment from the creditor. *Id.* at 391. Thereafter, the creditor coerced the debtor into transactions that were not in its interest and used its power under the strategic partnership agreements—and specifically its threat of not allowing further draws under its line of credit—to force the debtor to purchase unnecessary equipment when the debtor lacked sufficient funds to purchase it. *Id.* at 397. In one "egregious example," the creditor "applied pressure on [the debtor] to help [the creditor] make its end of quarter numbers," even though it knew that the debtor's executives were "vehement that they are out of money and d[id] not want to spend money on products they cannot immediately utilize." *Id.* at 393. Nevertheless, the creditor ultimately "forced [the debtor] to pay $135 million for software it did not need, did not use, and had a fair market value of substantially less than the contract price." *Id.* at 398.

[37] *Bergquist v. First Nat'l Bank of St. Paul (In re Am. Lumber Co.)*, 5 B.R. 470, 477–78 (D. Minn. 1980) (holding that a secured lender exercised a substantial level of control over the debtor due to, among other things, the lender's 1) ability to obtain a controlling interest of the debtor's stock; 2) its *de facto* control over the debtor's cash flow; 3) ability to force termination of the debtor's employees; and 4) unilateral control over which other creditors of the debtor would be paid); *but see Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1357–58 (7th Cir. 1990) (refusing to the subordinate the claim of a lender who had provided debtor with pre-petition and post-petition financing after it ceased providing financing to debtor two months after the petition date where the loan agreement provided for cancellation of the credit line on five days' notice); *Holt v. FDIC (In re CTS Truss, Inc.)*, 868 F.2d 146, 149 (5th Cir. 1989) (holding that a bank's alleged failure to fund notes executed by the borrower and its refusal to provide additional financing pursuant to an oral agreement were insufficient to warrant equitable subordination because the bank was neither a fiduciary of the borrower nor in a position of control, and other creditors were not harmed as a result of their reliance).

[38] *LightSquared LP v. SP Special Opportunities LLC (In re LightSquared Inc.)*, 511 B.R. 253, 348 (Bankr. S.D.N.Y. 2014) (internal quotations omitted).

In commercial cases, the movant must show that the lender substantially breached its loan documents and obtained a significant advantage.[39] Absent a breach of contract, the movant must demonstrate that the lender engaged in fraud, misrepresentation, estoppel, or similar conduct that justifies the intervention of equity.[40]

Depending on the particular circumstances of a case, all or a portion of a claim may be subordinated to some or even all other claims. A court will subordinate the claim of a creditor engaging in proscribed behavior only to the claims of those creditors that were actually injured by the inequitable conduct.[41] Moreover, courts are unlikely to order equitable subordination when a non-insider lender (or a lender exercising virtually complete control so as to be treated as a fiduciary) has simply exercised its rights under a loan agreement.[42]

Accordingly, secured lenders should avoid developing a close financial or managerial relationship with their borrowers and crossing the line from enforcing their contractual rights to impermissibly using bargaining leverage to control the borrower's business affairs. In addition, loans should be provided on market terms, including interest rate, payment terms, and fees, to ensure that loan documents are not susceptible to subsequent challenge.

Conclusion

While it is a truism that eliminating all risk of alleged "lender liability" claims in the context of distressed commercial lending is impossible, there are many ways for a secured creditor to reasonably manage or minimize such risks. This article discusses a few of those risk management techniques viewed through the lens of reported case law and basic best practices for lenders managing troubled credits. With foresight and critical thought, many risks that at first glance may seem unforeseen, can in fact be foreseen and minimized. Armed with the right set of tools, procedures, processes, knowledge, and insight, light can be shed on variables that lead to litigation risk, allowing lenders and their advisors to manage risk in a more prudent fashion.

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[39] *80 Nassau Assocs. v. Crossland Fed. Sav. Bank (In re 80 Nassau Assocs.)*, 169 B.R. 832, 837 (Bankr. S.D.N.Y. 1994)).

[40] *In re LightSquared Inc.*, 511 B.R. at 348.

[41] *Official Comm. of Unsecured Creditors of Sunbeam Corp. v. Morgan Stanley & Co., Inc. (In re Sunbeam Corp.)*, 284 B.R. 355, 364 (Bankr. S.D.N.Y. 2002).

[42] *See, e.g., In re Aeropostale, Inc.*, 555 B.R. at 409 (refusing to subordinate a claim of a creditor, which was an equity holder and had the ability to appoint the debtor's board members in exchange for, among other things, a $150 million loan, where the creditor did not take actions that stepped over the line into impermissible conduct to further its interest in a way that damaged the debtor or the bankruptcy estate).