REGULATORY UPDATE

Craig Weiner, partner, and Michael Kolcun, associate, at Robins Kaplan LLP, offer an overview of common sources of lender liability exposure in New York

Lenders must exercise considerable caution when seeking recovery when a debt becomes due. Borrower-initiated lawsuits are frequent because once in default, a debtor has nothing to lose and everything to gain. The mere threat of expensive and protracted litigation – or worse, a debtor's success – can increase leverage in forbearance negotiations or even achieve cancellation of debt altogether.

While the term 'lender liability' refers to exposure under numerous theories, borrower claims are primarily based on straightforward contract and tort law principles. The following discussion illustrates the most frequent areas of lender exposure under New York law.

CONTRACT LIABILITY

The creditor-debtor relationship is a contractual one, so a lender must take care to avoid breaching any written, oral, or implied agreement. Contract claims are relatively uncomplicated, but may arise in various situations such as oral modifications to a loan, waiver of certain obligations, commitments to funding, or promises to refrain from exercising certain remedies upon default.

One catch-all theory borrowers commonly assert is the implied covenant of good faith and fair dealing. Though unnecessarily verbose, this claim simply means a party breached its implied duty to refrain from taking action that would injure another party's fruits of the contract.

These theories are often creative, which can needlessly drag out litigation on otherwise baseless claims. That said, such claims usually tag-along with a separate breach of contract claim, which a lender should seek to dismiss as duplicative. Additionally, the implied covenant only applies to contract performance, and therefore, does not encompass negotiations, extensions, modifications, or settlement discussions.

New York courts also hold the implied covenant does not undermine a party's right to act in its own interests, even if doing so lessens another party's expected benefits. For example, the southern district of New York recently dismissed a borrower's good faith and fair dealing counterclaim based on a lender's refusal to consent to refinancing, finding the lender assumed no obligation to make repayment easier.

While parties to a contract must act in good faith and deal fairly, lenders will not typically be held responsible for aggressively pursuing repayment so long as they do so reasonably and in accordance with the enumerated rights and remedies in the contract.

TORT LIABILITY

Common law and statutory tort theories also pose potential threats. These theories are also diverse, but conduct that typically generates liability includes fraudulent misrepresentations, unwarranted exercise of control, and acting maliciously when a loan is in default.

Under New York law, fraud arises when a misrepresentation is made to a material fact that is false, known to be false, and induces reliance. In many circumstances, fraudulent misrepresentation claims involve unfulfilled promises to provide future funding or extensions of credit. A lender may be susceptible to damages if it had no intention of honoring its obligations when making them. Proving deceit may be a difficult burden, however, as borrowers must satisfy a heightened pleading standard.

AS A RECENT FEDERAL COURT DECISION DEMONSTRATES, COLLUDING TO GAIN CONTROL OVER A BORROWER'S BUSINESS AFFAIRS, COUPLED WITH THE THREAT OF FORECLOSURE, MAY SUBJECT A LENDER TO SUBSTANTIAL LIABILITY

A lender may also face exposure if it deviates from the typical creditor-debtor relationship by exercising substantial control over a borrower's operations. As a recent federal court decision demonstrates, colluding to gain control over a borrower's business affairs, coupled with the threat of foreclosure, may subject a lender to substantial liability.

New York courts also recognize a cause of action for prima facie tort, which can generate liability if an intentionally unlawful act is taken to injure a borrower if, for example, a lender intentionally seeks to drive a debtor out of business. Coercion and duress are further sources of liability. But as the case law indicates, the risk of exposure can be decreased if a lender avoids acting maliciously and does not threaten action that is unavailable under the parties' contracts or the law.

Lenders should be mindful of the low-risk/high-reward of borrower-initiated litigation. Debt recovery may carry risks of liability, but exposure can be avoided if lenders abide by the terms of their contracts and act with discretion when dealing with defaulted borrowers. The exercise of reasonable, but firm, action in recouping an investment will generally avoid any unwarranted vulnerability. ■