Published on *The National Law Review* https://natlawreview.com

Preventing Lender Liability: A Cautionary Case Study

Article By:

Kimberly A. Baber

Brendan G. Best

Michael J. Romaya

Kristen M. Veresh

In lending, the importance of full, transparent and accurate communications with a borrower cannot be overstated. In times of trouble, a lender must closely monitor a borrower's activities and ensure not only that the lender takes any actions necessary and permissible under its loan documents but also that its borrower is taking the steps necessary to preserve the lender's collateral.

While a distressed borrower (and sometimes its other creditors) may feel the lender is "giving the borrower advice" or even "taking over," a lender must remain focused on strictly adhering to the terms of its loan documents, preserving its collateral and ensuring the borrower remains completely independent and in full control of its operations. Rather than taking a "do-it-yourself" approach and risking a result similar to the lender in *In re Bailey Tool & Mfg. Co.* (discussed below), if a borrower's control over a business is unacceptable due to mismanagement, fraud or any other reason, the lender should quickly evaluate legal options to protect its collateral, including a possible receivership or bankruptcy case.

Recent Case Study

The recent opinion issued on December 23, 2021 in In re Bailey Tool & Mfg. Co. (Bankruptcy Court, Northern District of Texas) serves as a textbook example of lender overreach and reminds us of the critical importance of maintaining transparency and independence in lending. In 2014, the borrower was asked to exit its existing lender, Comerica Bank. At that time, the borrower had several new business lines, valuable contracts and an enterprise value of approximately $6 million. To accomplish the exit from Comerica Bank, the borrower then entered into discussions with Regions Bank for a new lending arrangement. As part of the move, Regions Bank suggested the borrower utilize a factoring and inventory financing lender for a few months as a "bridge" to get from Comerica Bank over to Regions Bank. One of the companies Regions Bank recommended for factoring was Republic

Business Credit, LLC ("Republic"). In March 2015, the borrower ultimately entered into factoring and inventory financing agreements with Republic pursuant to agreements that the Bankruptcy Court described as "not a model of clarity."

After receiving its first draw request from the borrower, Republic sent over a Borrowing Base Certificate showing ineligible accounts had jumped from $17,000 shown on the pre-closing pro forma Borrowing Base Certificate to $142,310.87 and further showed *negative* availability of $342,978.27 for purposes of account receivable factoring! By July 2015, Republic caused the borrower to close by refusing to release funds for payroll, causing its employees to walk off the job. In the aftermath, Republic then "became involved in trying to get management of its choosing in the Company and otherwise micromanaging the Company" and began putting pressure on the borrower's owner to give a lien on his exempt homestead. On one phone call, a Republic loan officer told the principal of the borrower and its financial advisor that he "shut down" the borrower because he was "tired of it" and attempted to convince the financial advisor to assume complete control. The borrower ultimately filed for Chapter 11 bankruptcy in February 2016 in the hopes of salvaging its business and effectuating a sale or reorganization.

The Cost of Lender Liability

Post-petition, Republic seems to have doubled down on its misbehavior by violating the automatic stay in bankruptcy, refusing to turn over approximately $584,250 of monies that it *over-collected* from the borrower *after completely paying off its loan* unless the borrower agreed to give them a release from potential lender liability claims. The delays caused by the refusal to turn over the funds sabotaged the borrower's efforts to facilitate a sale or reorganization process and caused the bankruptcy cases to convert to Chapter 7. The Chapter 7 Trustee then commenced an investigation into the pre-petition activities and filed a lender liability lawsuit against Republic.

The Bankruptcy Court ultimately ruled that Republic, among other things, (i) misrepresented the amount of funds available to the borrower, (ii) charged excessive, undisclosed fees and penalties, and (iii) refused to turn over funds and took complete control of the borrower's finances, causing the Company to completely shut down. **Republic was held liable for $17 million in damages as well as over $700,000 in Chapter 11 and Chapter 7 administrative expenses, *i.e.* it was forced to pay for the entire cost of the bankruptcy proceedings**.

Lender Liability in Other Cases

While an extreme lender liability case like *In re Bailey* is rare, adverse lender liability rulings do happen with some frequency. Before *In re Bailey*, there were a number of other cases the resulted in lawsuits against lenders:

- In re Island View Crossing II, L.P. (Bankruptcy Court, Eastern District of Pennsylvania, August 24, 2021) (denying lender's motion for summary judgment where lender's extreme delay in funding several draw requests prior to the borrower's default could support the inference that such delays were a breach of the agreement and caused damage to the borrower's real estate projects) (*settled for $8.3 million dollar payment from lender to debtor's bankruptcy estate*)

- Armstrong v. White Winston Select Asset Funds, LLC (Massachusetts District Court, March 23, 2020) (denying lender's motion to dismiss where lender was dishonest throughout its dealings with its borrower and took control over borrower's finances through its exclusive control of a lock box account that allowed lender to make decisions as to amounts to be released to the borrower's other creditors) (*case is pending*)

- Indus. Tech. Ventures LP v. Pleasant T. Rowland Revocable Tr. (New York Western District Court, April 28, 2015) (denying lender's motion for summary judgment where lender and the borrower's CEO colluded to gain control of the company by leveraging the threat of a foreclosure to leave the borrower's board without a viable alternative) (*settled under undisclosed terms*)

These cases serve as additional reminders to lenders to steer clear of the kind of behavior shown in the *Bailey* case. Or, in the words of one veteran workout counsel: "If it feels good… don't do it!"

National Law Review, Volume XII, Number 139

Source URL:https://natlawreview.com/article/preventing-lender-liability-cautionary-case-study