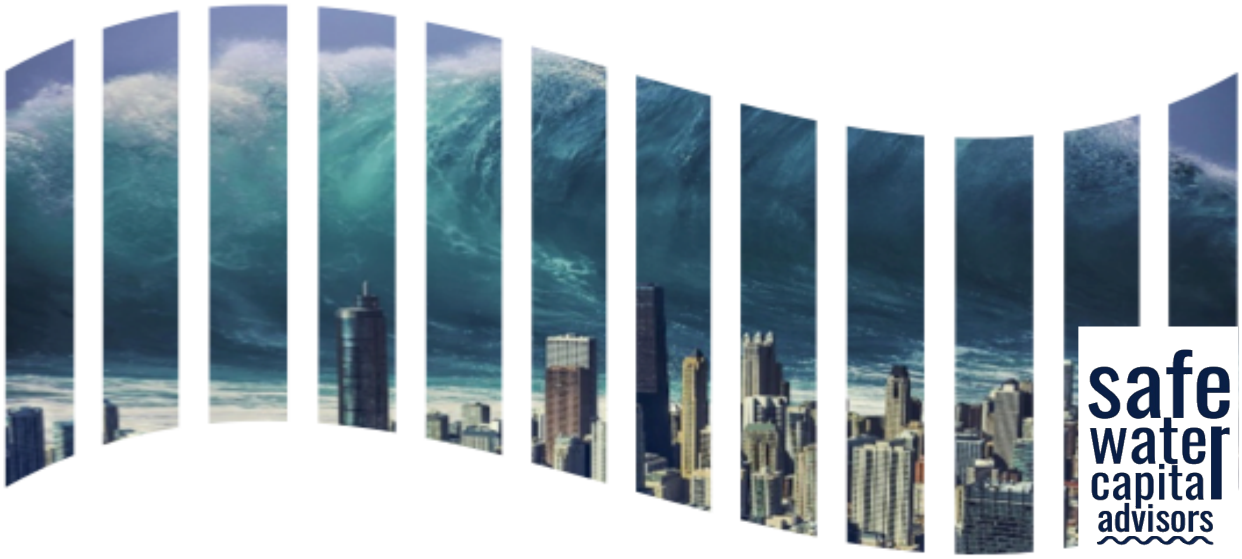
WHAT IS THE BIG DEAL ABOUT LENDER LIABILITY?



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Texas is the home of the first big lender liability case. Thirty-nine years ago, a jury found (after a more-than-two-month trial) that a bank lender, acting alone or in conspiracy with two other lenders, committed acts of fraud, duress, and interference, proximately resulting in damages to the Farah Manufacturing Company, and set **damages at $ 18,947,348.77 on roughly a $6 million loan participation in a $22MM credit facility**.

For those commercial bankers who were around back then, lender liability training was constantly being pushed – similar to AML training today. Here are some of the key points from that training:

1. **Draft protective loan documents** – no oral modifications clause and clear juristiction and venue agreement.
2. **Be professional –** always act in good faith and don't commit fraud – assume all communications (including internal) can be evidence in court. Profane language and sarcasm do not reflect well in litigation. Try to limit text's and emails – both externally and internally.
3. **Don't act without consulting the contract and legal counsel** – to avoid a potential breach of contract.
4. **Obtain a second set of eyes after default** – from a workout lender, whenever possible.
5. **Don't make promises** – beyond what is in the loan agreement.
6. **Document all oral communications** - This can be done by a simple email to the borrower summarizing what was discussed, and a reminder to the borrower that the bank reserves its rights and remedies.
7. **Make all agreements in writing** - if a default arises, it should be addressed through a reservation of rights letter, waiver letter, amendment, or forbearance agreement.

8. **Don't give advice to the borrower** – avoid actions that give the appearance of being involved in directing the borrower's business, including: (a) having an actual or contingent ownership interest in a borrower or serving on a borrower's board of directors, either directly or indirectly through a nominee, (b) deciding which creditors get paid or who will manage the borrower or be on its governing board, (c) dictating who the borrower should hire as a management consultant, although the lender may require that a distressed borrower retain a financial consultant acceptable to the lender, (d) drafting or dictating a business plan, although the lender may require that the borrower develop and implement a business plan that is acceptable to the lender, or (e) setting forth how the borrower will use its cash, other than to verify that payroll, payroll taxes and sales taxes are paid.
9. **Be cautious when considering default remedies** - Think twice before terminating a credit facility based on a non-payment default, particularly if similar defaults have occurred in the past without any remedial action or a written reservation of rights letter. Unless a compelling reason exists for immediate action, the lender should also give its borrower reasonable prior notice and an opportunity to obtain alternative financing before terminating or accelerating a credit facility or foreclosing on collateral. A lender should be prepared to explore all realistic alternatives before terminating or accelerating a credit facility, such as a work-out or restructuring where the lender receives an acknowledgment of debt and a release of claims. A lender that exercises patience is more likely to appear reasonable and fair.
10. **Maintain open lines of communications with the borrower** – this goes to good faith and the spirit of the agreement.
11. **Keep a detailed loan file** – of essential documents including loan documents, financial reports and communications about, or with, the borrower.

Unfortunately, senior lenders do not insist on this training as much any more – and successful cases against lenders **are almost always settled with a confidentiality agreement**. So many lenders are not even aware of the pervasiveness of cases in the market. As recent as December 2021, another Texas case "**Bailey Tool and Manufacturing Company**" resulted in **damages in excess of $17 million on a $2.5 million factoring agreement.** The Dallas court found the debtor's pre-petition inventory and receivables lender liable for breach of loan documents, breach of duty of good faith and fair dealing, fraud (through fraudulent misrepresentations) and tortious interference with business and contractual relationships.

In fact, the majority of SafeWater's restructuring cases over the past three years had some level of lender liability exposure – some of which was just as egregious as above. Because of the time and expense necessary to pursue a lender liability claim, we will typically advise undercapitalized borrowers to negotiate a better outcome in exchange for a mutual release agreement. However, sometimes the expected damages are too large to ignore, and special counsel is brought in to pursue a case outside of the restructuring. Lenders should understand this risk and be willing to work with borrowers to try to get to a fair outcome.

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