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Welcome to another issue of the *Commercial Lending Bulletin*, a newsletter published monthly by the Commercial Lending Group at Lerch, Early & Brewer as a service to our clients. Here, you will find articles written by our attorneys covering a variety of current legal issues as they affect lending law. We publish the *Bulletin* as part of our ongoing efforts to provide our clients with responsive service and practical advice when needed.

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FAMM Steel Inc., a once-profitable family-owned steel manufacturing company, was unable to hold its primary lender liable for forcing it to make decisions that led to the company's financial collapse. The 1st U.S. Circuit Court of Appeals agreed with the U.S. District Court, District of Massachusetts that the company could not use the "instrumentality" theory to prevail against its lender.

In 1995, FAMM had sales of \$1.8 million. In 1998, the company developed a plan to expand its facility and upgrade its operations by investing in state-of-the-art equipment. By 2002, FAMM's annual sales had increased to \$27 million. The company's expansion and improvements were funded by Fleet National Bank, the predecessor-in-interest to Sovereign Bank. Between 1998 and 2002, the bank extended approximately \$6.1 million in credit to FAMM.

However, FAMM suffered an operating loss during the fourth quarter of 2001 and suffered a further setback when the company's comptroller announced that he was leaving at the end of the year. In January 2002, FAMM's president, Ann Gavin, spoke with a Fleet vice president, Edward Powers, about the company's plan to replace the comptroller. Powers said he wasn't comfortable with FAMM's choice of an interim replacement and suggested that the company hire David Lee. Gavin objected, but Powers insisted, stating that it was Fleet's prerogative to have the company hire someone with whom the bank was comfortable. FAMM acquiesced and hired Lee as the interim replacement.

In March 2002, FAMM hired Keith Woolford as its new comptroller. At the bank's direction, Lee remained with the company to train and supervise Woolford and to provide general oversight for FAMM's accounting department. As a result of its losses in 2001, FAMM defaulted on the Fleet loan in February 2002 and remained in default through 2003. The company's problems were exacerbated by the mismanagement of the company's finances by Lee and Woolford. For example, FAMM anticipated a \$300,000 profit in 2002, but learned late in the year that it actually was going to lose more than \$1 million. The error was due to inaccurate financial information.

In January 2003, Powers directed Gavin to hire Joe Picano, a Fleet-approved turnaround specialist. Powers promised that FAMM's account would remain with him if Picano was retained. Nevertheless, two months later, FAMM's account was transferred to the Fleet's Managed Assets Division. During 2003, the bank engaged in activities that Gavin said were intended "to close FAMM, minimize [the bank's] exposure and maximize the value of its credit." In March 2004, Fleet sold FAMM's loans for \$1.725 million. After the sale, FAMM's facility was closed and its assets sold. Fleet lost more than \$4 million. In December 2006, FAMM filed a 12-count complaint against the bank alleging that the company's downfall was caused by the bank's actions, starting with the bank's forcing FAMM to hire Lee. The District Court granted summary judgment to the bank in June 2008. The 1st Circuit affirmed.

This case presented the 1st Circuit with its first opportunity to consider the "instrumentality" theory of lender liability. Where this theory is recognized, lenders may be liable if the facts unmistakably show that the lender has assumed actual and participatory control of the borrower so as to render the borrower subservient to the lender. However, if the borrower continues to show signs of independent action, then the theory does not apply.

The instrumentality theory is similar to "piercing the corporate veil," where a director or shareholder exerts so much control over the corporation that the director or shareholder is held responsible for the corporation's actions. It is important to note, however, that the object of veil piercing and the instrumentality theory is to protect third parties who believe they are dealing with one party but later learn that the party was hiding behind a corporate entity. The instrumentality theory goes further by holding one creditor liable to other creditors if the creditor exercised such control over the debtor that it favored the dominant creditor to the harm of the other creditors. In both situations, the instrumentality theory or the piercing the corporate veil theory is asserted by a third party, which was not what occurred in the FAMM case.

In the FAMM case, the plaintiff was a debtor seeking to use the instrumentality theory to recover damages from its own creditor. The First Circuit Court noted that, "Plaintiffs point to no cases that recognize this novel application of the instrumentality theory, and there is no indication that such an application would be accepted by the Massachusetts courts." It added, "Further, the District Court



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correctly found that, even under the usual theory, the facts alleged by plaintiffs cannot support the conclusion that [the bank] exercised sufficient control over FMM to give rise to liability. Of course, the mere existence of a creditor-debtor relationship does not by itself give rise to the level of control necessary for liability under the instrumentality theory; if it were otherwise, lenders would rightfully be reluctant to extend credit.”

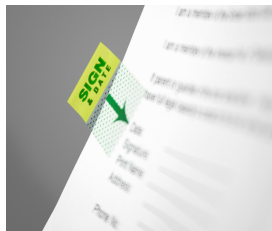
The Court found that even if the instrumentality theory could be asserted by FMM rather than by a third party, it would not apply because the bank did not exercise sufficient control over the company. While Powers pushed FMM to hire Lee, there was no evidence that Powers or the bank forced Lee’s actions, let alone that the bank had assumed actual and total control over the company’s affairs. Finally, given the amount of the bank’s losses, the First Circuit said it seemed implausible that the bank had taken control.

In a related allegation, FMM was unable to prevail on its claim that it acted under duress when it hired Lee because there was no indication that the bank violated the parties’ loan agreement by pressuring the company to do so. The Court explained that “if FMM was placed in a situation in which it had no choice but to hire Lee, this resulted only from a contractual business arrangement into which FMM freely entered, and not from any coercive acts on the part of [the bank].”

This case is cited as *FMM Steel Inc., et al., v. Sovereign Bank*, No. 08-1955 (First Cir. 06/12/09).

A Cautionary Tale for Lenders with Government Guarantees

A lender’s negligence in conducting due diligence and servicing a loan caused it to lose the benefit of a guaranty by the U.S. Government.



The D.C. Court of Appeals determined that the USDA is not liable under its guaranty of a loan to a catfish farm because of negligence by the lender in servicing the loan. The U.S. Department of Agriculture administers a government loan program, the Business and Industry Guaranteed Loan Program, under which the USDA guarantees private loans made to rural businesses for the purpose of fostering business, industry and employment in rural communities. Under the terms of the program, the private lender is responsible for all necessary due diligence and for servicing the loan, while the USDA guarantees the principal and interest provided that the lender does not violate usury laws and is not negligent in servicing the loan or in obtaining security for the loan. If the lender is negligent, the USDA guaranty is denied.

In this case, the USDA guaranteed 75% of a \$5 million loan made in 1999 by Enterprise Bank of Florida to Catfish, INT., Inc. for the purpose of building a catfish processing and distribution facility. The president of Catfish, Erwin David Rabhan, also guaranteed the loan. When Catfish defaulted on the loan, the USDA discovered that Rabhan and the general contractor had worked together to defraud both the USDA and Enterprise. Both men pled guilty to conspiracy and went to jail.

In November 2002, Enterprise reported a \$4,213,434 loss to the USDA and requested 75% of this figure, or \$3,160,075, as payment under the guarantee. The USDA denied the claim in full because their investigation indicated that Enterprise did not complete their due diligence in making the loan, was negligent in servicing the loan and did not comply with conditions contained within the guarantee. Enterprise appealed pursuant to the USDA’s procedures and eventually obtained a new ruling that the USDA’s initial ruling had been erroneous. However, without specifying what the USDA owed under the guarantee, this new ruling further confirmed the USDA’s prior investigation indicating that Enterprise had been negligent in servicing the loan. Specifically, Enterprise failed to ensure payment of a \$2.95 million equity injection by Catfish into the project and failed to make sure that Catfish built a required maintenance shed valued at \$80,000, resulting in a total loss of \$3.03 million. When the USDA finally implemented the new ruling, in March 2006, they reduced Enterprise’s loss claim by the value of the lost

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equity injection and the non-existent maintenance shed and only agreed to pay \$956,252.19 under the guarantee. Enterprise filed a complaint in district court and lost.

On subsequent appeal, Enterprise claimed that because the USDA's second ruling report did not specify what was owed under the guaranty, it required full payment of Enterprise's loss claim. However, the court determined that, because the ruling did not include a precise amount that the USDA owed Enterprise, it was reasonable to reduce the loss claim by the total amount of funds attributable to Enterprise's failures and negligence. Accordingly, the court upheld the ruling that only \$956,252.19 should be paid under the guaranty. In effect, as required under the Business and Industry Guaranteed Loan Program, the guarantee became unenforceable to the extent of the errors and omissions that Enterprise made in connection with the loan.

This case is cited as *Enterprise National Bank v. Vilsack*, 568 F.3d 229.

Lender Attaches Property No Longer Owned by Allegedly Insolvent Guarantor

A federal court in California determined that a guarantor cannot escape liability under a guaranty by transferring its property to a trust, allegedly to render itself insolvent.

In March 2007, The Crest at Memory Lane, LLC borrowed \$4,776,000 from Intervest Mortgage Investment Company to construct a 26-unit condominium complex. The loan was guaranteed by Kip and Illa Skidmore. The remainder of the \$6 million construction cost was to be made up with equity. The loan was secured by a deed of trust on the property. The guaranty, signed by the Skidmores, included various waivers, the most important of which allowed Intervest to pursue the guarantors primarily, without ever pursuing the borrower or foreclosing on the property. The guaranty further required the Skidmores to stay abreast of the construction and the financial status of the project and prohibited them from transferring "all or substantially all" of their assets without Intervest's consent.

By July 2007, mechanics liens were recorded against the property, after which the primary contractor lost its contractor's license and the expected equity contribution was never made. The project further stalled when various insurance, government, homeowner's association, and other fees went unpaid and other aspects of the project ran over budget. Intervest sent The Crest default letters in December 2007 and January 2008, and then in March 2008 threatened collection action if the defaults were not cured. On July 3, 2008, Intervest filed suit against the guarantors and Alaska Trust Company, a family trust to which the guarantor transferred certain assets. Intervest sought to attach \$4.25 million worth of the Skidmores' property, which represented approximately \$4 million due on the loan and \$250,000 in legal fees. The properties at issue included two residences and a timeshare the Skidmores transferred to Alaska Trust Company on November 28, 2007. The transfer deeds were not recorded until February 2008 and, according to the Skidmores, were made for estate planning purposes. In its suit, Intervest claims that the property was transferred to the trust to protect it from creditors, thus rendering the Skidmores insolvent.

The Court stated that a court order to "attach" or seize assets would be issued if i) the underlying claim was one on which an attachment could be issued, ii) the plaintiff established probable validity of the underlying claim, iii) the purpose of the attachment was recovery on the underlying claim, and iv) the amount to be secured by the attachment was greater than zero. The Skidmores argued that the underlying obligation of The Crest was secured, which, according to California Civil Code section 2809, precluded Intervest from proceeding against either The Crest or the Skidmores. However, because the guaranty contained specific provisions waiving the protections of section 2809, among other sections, the Court determined that Intervest not only was permitted to pursue the Skidmores, but was permitted to pursue them without first foreclosing on any collateral pledged by The Crest.

Regarding the second prong of the test for attachment, the Court stated that the majority of the Skidmores' counterclaims were inadequately pled, causing them to fail. Only their claim for unfair competition could be litigated and the Court, without elaborating, indicated that it was "more likely than

not that this claim will not reduce Intervest's recovery." Intervest further claimed that the Skidmores' transfers of their real estate to Alaska Trust Company were fraudulent under California law because they were made without exchange of value and left the Skidmores without enough assets to satisfy their obligations under the guaranty. The Court determined that Intervest was likely to satisfy its burden of proof because the Skidmores did not provide alternate financial documentation to prove they could satisfy their obligations under the guaranty. Because the Skidmores agreed to the guaranty without reliance upon The Crest's assets, and because they failed to provide evidence that they possessed sufficient assets to satisfy the guaranty, the Court found the second prong of the test was met.

After the third and fourth prongs of the test were clearly met, without discussion by the Court, it determined that the writ could attach to the real estate previously transferred by the guarantors.

This case is cited as *Intervest Mortgage Investment Company v. Kip S. Skidmore, et al.*, 2008 WL 5385880 (E.D.Cal.).

Tip of the Month: Check Payment of Real Estate Taxes Periodically



There has been a recent surge in real estate tax sales for failure of an owner to pay their real estate taxes when owed. Because many commercial loans do not require the borrower to escrow real estate taxes with the lender, the lender must make sure that real estate taxes are paid. If the taxes are not paid when due, significant penalties and interest accrue. In addition, the real estate may be sold at tax sale if the real estate taxes remain delinquent for an extended period of time, which varies by jurisdiction. This will result in additional expense, and possibly the loss of the real estate collateral if the property is not redeemed in a timely manner.

In the District of Columbia we recently have seen a surge in reclassification of properties to vacant properties. In many such instances, additional taxes were imposed retroactively. This is prevalent especially with real property under construction. The District of Columbia taxes "vacant property" at a significantly higher tax rate. While a property may be exempt from the higher "vacant property" tax rate, the property owner must take affirmative steps to register the property as vacant and claim the specific exemption. Many of these exemptions have a limited time period, so even if property may qualify for a specific exemption, once the time period for the exemption expires and if the property remains vacant, it will be taxed at the higher rate unless other exemptions are available. We have encountered several properties in the District of Columbia where the tax records reflected that all tax payments were current, and then a subsequent inquiry revealed a retroactive application of the vacant property tax rate. Lenders should be diligent in verifying real estate tax payments to avoid unnecessary and burdensome costs and potential losses in the future.

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