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"Responsive service and practical advice when you need it."

Lender Has No Duty To Disclose Financial Information of Borrower to Guarantor

The U.S. District Court for the Eastern District of Tennessee has ruled that a lender has no duty to disclose the financial condition of a borrower to a guarantor when there is no fiduciary relationship nor a specific request from the guarantor to the lender for such information.

Frederick McDonald, II guaranteed a $750,000 loan from National Bank of Tennessee to Southeast Machining LLC. The promissory note executed by Southeast Machining went into default and National Bank of Tennessee brought suit against McDonald, as guarantor. McDonald responded by filing a counterclaim against National Bank, alleging negligence and fraud. The essence of McDonald's defense and counterclaim was that National Bank was aware that Southeast Machining had been delinquent on some note payments and might be in financial trouble, and failed to disclose that information to McDonald when he executed the guaranty.

With respect to McDonald's counterclaim, the Court observed that under Tennessee law a lender has no duty of disclosure to a guarantor unless: 1) there is a previous fiduciary relationship between the lender and the guarantor; 2) the transaction is intrinsically fiduciary and calls for perfect good faith; or 3) the guarantor makes specific inquiries of the lender. In a fiduciary relationship, the Courts look for the presence of a relationship of trust and confidence between the parties. Applying these rules to McDonald's counterclaim, the Court ruled that none of these conditions were present in the instant case.

McDonald's guaranty expressly stated that National Bank made no representations about the creditworthiness of Southeast Machining, and that absent a request for information, National Bank had no obligation to disclose any information about Southeast Machining to him. The guaranty also stated that it was McDonald's responsibility to remain adequately informed of Southeast Machining's financial condition. Accordingly, the Court dismissed McDonald's counterclaim.

As demonstrated by this case, a guaranty should specifically state that the lender makes no representations to the guarantor of the financial condition of the borrower, disclaim any duty to advise the guarantor of any changes in the financial conditions of the borrower, and disclaim any fiduciary relationship between the lender and the guarantor.

This case is cited as *National Bank of Tennessee v. McDonald, No. 2:03-CV-401 (E.D. Tenn. 10/31/06).*

The Importance of Obtaining a Purchase Money Security Interest

The Court of Appeals of Utah has determined that, where a new lender pays off what was originally a purchase money security interest and then finances a new loan to a new entity covering the same collateral as the original loan, the original purchase money security interest is extinguished even though the new loan covers the same collateral.

In 1998, New Holland Credit Company financed Pali Brothers Farms' purchase of two combines, and properly perfected a UCC Financing Statement. (A purchase money security interest will have priority over all other security interests filed either before or after the filing of a purchase money security interest.) In 2000 and 2001, Pali Brothers obtained two different loans from Lewiston State Bank secured by all of the Pali Brothers' equipment, both present and future. The Bank properly perfected UCC Financing Statements covering each loan. Pali Brothers then defaulted on the New Holland loan.

In 2002, Greenline Equipment, L.L.C. refinanced Pali Brothers' outstanding New Holland debt and received a lien release from New Holland on the combines. The two Pali brothers then, as individuals, obtained a loan from John Deere & Company to purchase the combines from Greenline. John Deere properly filed and perfected UCC financing statements regarding the combines. Pali Brothers then defaulted on Lewiston Bank loan and the individual brothers defaulted on the John Deere loan. John Deere took possession of the combines. Lewiston Bank sent John Deere a demand letter asserting that it had priority over the equipment. After John Deere assigned its interest in the combines to Greenline, Greenline then sold the two combines and failed to notify the Bank of the sale. In 2003, the Bank sued Greenline for the selling of the collateral without payment to Lewiston Bank.

The trial court found that the Bank's security interest in the combines was superior to Greenline's, and Greenline appealed. The appeals court determined that, under the Uniform Commercial Code, a purchase money security interest terminates when the original purchase-money obligation is satisfied, unless the security interest is refinanced with the original secured party or its assignee. If a new creditor subsequently extends credit to the debtor in exchange for a security interest in the same collateral, the new security interest does not retain the original purchase money status. Here, because Greenline obtained a lien release from New Holland, New Holland's purchase money security interest was extinguished and Lewiston Bank's lien, next in line to New Holland, attained priority status over any subsequent lien.

This case highlights the importance of obtaining an assignment of a purchase money security interest instead of a lien release if a lender intends to retain the purchase money security interest in the collateral.

This case is cited as *Lewiston State Bank v. Greenline Equipment, L.L.C. 147 P3d 951 (2006).*

Failure to Dispose of Collateral in a Commercially Reasonable Manner Bars Recovery Under Article 9

The District Court of Appeals in Florida recently held that a lender who failed to dispose of collateral in a commercially reasonable manner was barred from recovery under Article 9 of the Uniform Commercial Code.

New Vision Eye Center received a loan from Wachovia Bank which was secured by the business accounts, inventory, and equipment of the business, as well as the personal guarantees of Dr. Boutros and Dr. Minoso, who owned the business. When New Vision stopped operating, Wachovia placed a lien on the physical assets of the business. Boutros then took possession of the business equipment, stored the equipment in a warehouse and paid the loan in full. At Dr. Minoso's request, Wachovia then assigned the note and security agreements from the loan to him. Boutros sued Minoso to recover Minoso's guaranteed portion of the loan. Boutros made a claim for equitable contribution and unjust enrichment. The trial court found that Minoso had an equitable duty to repay the his guaranteed portion of the loan and found that he owed Boutros $186,000, but the trial court also found that Boutros had failed to prove the value of the assets in the warehouse. Based on Boutros' failure to establish the value of the assets, the trial court held that Boutros could not recover any money from Minoso.

In discussing relevant case law, the trial court found that once a party has taken possession of secured collateral, one remedy is to sell, lease or dispose of such collateral in a commercially reasonable manner as de-

scribed in Article 9 of the Uniform Commercial Code. The Court noted that a disposition of property in a commercially reasonable manner "prevents the creditor from acquiring the collateral at less than its true value or understating its value so as to obtain an excessive deficiency judgment." Boutros had possession of the property, but had failed to sell or dispose of it and, therefore, the Court held he could not recover as a secured party under Article 9. However, the Florida Court of Appeals reversed the trial court decision regarding Minoso's liability as a co-guarantor for the loan. The Court found that although Article 9 barred Boutros' claim as the secured creditor now holding the note, he maintained rights as to co-guarantor, which could be exercised in an action against Minoso.

This case illustrates the importance of lenders acting in a commercially reasonable manner when dealing with collateral in order to successfully pursue remedies against a guarantor.

The case above is cited as *Boutros v. Minoso, Case No. 3D05-1849 & 3D05-1773 (District Court of Appeal of Florida, Third District, July 2006)*

Practice Tip: *Commitment Letters*

In today's competitive lending environment, term sheets and commitments are often issued based upon partial information and then, in many cases, need to be extended due to delays in obtaining necessary approvals, permits, consents or other documentation. During the review process, the lender and its counsel are likely to be expending significant time and effort and incurring considerable expense, only to find out that the original assumptions are false or, with the passage of time, that there has been a material change in circumstances to the borrower, guarantor, or the transaction itself. When this happens, the transaction may no longer meet the lender's underwriting, legal or documentation requirements.

Unfortunately, in the rush to issue a term sheet, or if the term sheet is attached to a commitment letter that is essentially a transmittal letter, the rights of the lender to terminate the commitment and the obligation of the borrower and guarantor to pay the costs and expenses incurred are not clearly established. Therefore, it is important that as a lender, you obtain an executed commitment letter, and that the commitment letter contain a provision similar to the following clause to clearly establish these rights and obligations:

"This commitment is being made in reliance upon the information supplied by the Borrower and the Guarantor to the Bank in connection with the Loan. If the Bank, acting in good faith, should determine that any such information or supporting representation of a material nature is false, inaccurate, incomplete or misleading, the Bank may rescind and cancel this commitment and retain all fees theretofore paid to the Bank. In addition, the Bank shall have no obligation to fund the Loan and shall have the right to retain all fees theretofore paid to the Bank in the event that, in the sole judgment of the Bank, prior to the Loan Closing, there shall be a material adverse change in the value or condition of the collateral, or if the Borrower or the Guarantor shall be involved in any arrangement, bankruptcy, reorganization or insolvency proceeding or shall have suffered any adverse change in his, her, its or their financial condition or if any other event shall occur which would constitute an event of default under the Loan Documents. The Borrower and the Guarantor shall nevertheless remain liable for all of the Bank's expenses, including attorneys' fees, in connection with the Loan."

If a lender is not having the commitment letter prepared or reviewed by counsel, the lender should consider consulting with counsel on a periodic basis to confirm that the forms the lender is using adequately protects the lender in this important area.

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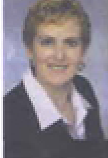

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Lerch, Early & Brewer's **Litigation Group** represents banks and other financial institutions in a broad array of commercial and lending-related matters. When a commercial loan goes into default, our professionals assist our clients in related litigation matters, including general loan "work out" situations/debt recovery, letter of credit disputes, and insurance and fraud matters. Additionally, our attorneys represent a broad spectrum of business clientele in commercial litigation involving contract disputes, fraud, breach of fiduciary duty and unfair competition matters, corporate, partnership and shareholder disputes and derivative claims.

For more information about the firm's Litigation Group, please visit www.lerchearly.com/services/litigation.cfm.

Coming Soon

In May, members of the Commercial Lending Group will be presenting a seminar on 504 loans. Be sure to look for future issues of the *Bulletin* for details on this upcoming event.

If you do not wish to receive the Bulletin in the future or you would like to receive this Bulletin only by e-mail, please call Ben Harris at (301) 961-6096 or e-mail him at *BJHarris@lerchearly.com.*

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