

LERCH EARLY &amp; BREWER

# Commercial Lending Bulletin

October 2008

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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.

This newsletter is sent via email in HTML format. If you wish to print a copy of the newsletter, you may access a .pdf version by following the "Printer-Friendly version" link below.

We appreciate any feedback and invite you to contact us with any questions. If you do not want to receive any further newsletters from us, follow the link at the bottom of this email to be removed from our list of recipients.

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## In This Issue:

### **Oral Promise To Lend Becomes Expensive Lesson For Lender**

The U.S. District Court in Nebraska has held that a bank can be liable under a promissory estoppel (reliance) theory for promising to lend money to a customer who settles a lawsuit based on the promise that the loan will be made.

### **Perfection Of A Security Interest Is Discretionary And Is Not A Duty Of Lender**

In litigation arising from a complex sale-leaseback arrangement, a debtor was unable to prove that its creditor was liable for financial harm to the debtor due to the fact that security interest in the collateral was never perfected. A state appellate court held that the security interest was for the creditor's protection and may or may not be perfected at the sole discretion of the creditor, and that the creditor's failure to perfect that interest created no claim for the debtor.

### **Court Rejects Mutual Mistake Defense**

A U.S. District Court in Texas found that guarantors could not reform their guaranties under the doctrine of "mutual mistake" when there was no evidence that the guaranties did not reflect the lender's intent and mutual mistake can exist only if a document contradicts the intent of all parties involved.

### **Seminar Alert!**

Look out for a seminar on October 28th presented by Art Lafionatis and Ray Sherbill titled "Strategies for Lenders and Business Owners When Fundamental Changes Occur." Also, on November 20th a seminar is scheduled discussing issues concerning what lenders need to know about the SBA repurchase process to ensure timely payment of the SBA Guarantee. Alison Rind and Arnold Spevack will discuss tips to maximize your ability to collect the SBA Guarantee.

### **Oral Promise To Lend Becomes Expensive Lesson For Lender**

**THE U.S. DISTRICT COURT IN NEBRASKA HELD THAT A BANK CAN BE LIABLE UNDER A PROMISSORY ESTOPPEL THEORY FOR PROMISING TO LEND MONEY TO A CUSTOMER WHO SETTLES A LAWSUIT BASED ON THE PROMISE THAT THE LOAN WILL BE MADE.**

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Michael and Joseph Carnazzo formed Fortress Systems LLC in 1994. After a merger was complete between the Carnazzos and a company owned by John Houston, Houston and the Carnazzos met with Christy Edwards and Richard Osher of Bank of the West to discuss the financing of a manufacturing facility. The Carnazzos informed the Bank of a pending shareholder buyout lawsuit and also provided the Bank with Fortress' financial statements, copies of leases and other contract information. In response to the bank's request, Fortress increased the lease term of the new facility, and the Carnazzos invested \$320,000 of their own money in the new facility.

On November 30, 2001, Bank of the West issued a commitment letter to Fortress for a \$2.2 million construction loan and a \$1 million revolving line of credit. On December 10, the Bank informed the Carnazzos that the loans to Fortress would not be made unless the pending shareholder lawsuit was resolved. Based upon these statements, Fortress signed an "Intent to Settle" with the shareholders with unfavorable terms to Fortress; Fortress also signed agreements with contractors to build the manufacturing facility. Furthermore, the Bank continued to request financial and sales contract information from Fortress. Subsequently, the Bank advised Fortress that it would not make the original loan, and Fortress sued the Bank under a theory of promissory estoppel.

The U.S. District Court in Nebraska held that under Nebraska law promissory estoppel is "a promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance [and is] binding if injustice can be avoided only by enforcement of the promise." The District Court noted that promissory estoppel requires that reliance be reasonable and foreseeable.

The Bank argued that the commitment letter was a statement of opinion or future intent, and not a promise. The Court said that while the commitment letter was not sufficient to constitute a promise under the promissory estoppel theory, there was sufficient evidence that the Bank affirmatively promised to close the loan if the shareholder lawsuit was resolved. Accordingly, the Bank should have foreseen that its actions would cause Fortress to act in reliance on its promise since the evidence showed that the Bank knew that Fortress was attempting to settle the lawsuit, that construction had already begun on the new building, and that the Carnazzos had already spent their own money on the build-out to get the loan.

The District Court held that Fortress provided sufficient evidence for a finding of promissory estoppel, and that Bank of the West was liable to Fortress for \$1,647,845.24, which was the amount Fortress actually paid on the building contract.

This case illustrates that a statement or conduct by a bank officer to make a loan to a prospective borrower may bind a lender to make such a loan, even if the statement was oral. While documentation techniques will not prevent a borrower from arguing that oral representations were made regarding the terms of the commitment, courts are less likely to uphold an oral promise when the terms of a mutually binding commitment letter clearly spell out the material terms for making the loan. Here, the lender increased its exposure to liability by adding a material condition to lend after the commitment letter had been signed. Lenders should ensure that their commitment letters set forth all of the material conditions precedent to the lender's obligation to lend. If such conditions are not satisfied, no obligation to lend will arise.

This case is cited as *Fortress Systems, L.L.C. v. Bank of the West*, 2008 WL 64690 (D.Neb. Jan 03, 2008) (No. 8:06CV283).

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### **Perfection Of A Security Interest Is Discretionary And Is Not A Duty Of Lender**

**IN LITIGATION ARISING FROM A COMPLEX SALE-LEASEBACK ARRANGEMENT, A DEBTOR WAS UNABLE TO PROVE THAT ITS CREDITOR WAS LIABLE FOR FINANCIAL HARM TO THE DEBTOR DUE TO THE FACT THE CREDITOR'S SECURITY INTEREST IN THE COLLATERAL WAS NEVER PERFECTED. A STATE APPELLATE COURT HELD THAT A SECURITY INTEREST WAS FOR THE CREDITOR'S PROTECTION AND MAY OR MAY NOT BE PERFECTED AT THE SOLE DISCRETION OF THE CREDITOR, AND THAT THE CREDITOR'S FAILURE TO PERFECT THAT INTEREST CREATED NO CLAIM FOR THE DEBTOR.**

William R. Rush was the president of North American Truck & Trailer and Carolina Commercial Truck Sales LLC. U.S. Bancorp Equipment Finance Inc. provided financing to North American in the form of a sale-leaseback transaction in which North American purchased 20 Volvo trucks, sold them to U.S. Bancorp, which leased the trucks back to North American. A "power of attorney" clause in the lease stated that U.S. Bancorp had authority to complete and execute financing statements to perfect North American's security interest in the collateral.



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Thereafter, North American subleased the trucks to Carolina, and assigned its interest in the sublease to U.S. Bancorp. Carolina executed a security agreement in favor of U.S. Bancorp, granting it a security interest in the trucks. The security agreement contained a "warranty" clause which stated that "at the request of the Secured Party, Debtor will execute, acknowledge and deliver to Secured Party in recordable or file able form, any document or instrument required by the Secured Party ... to perfect its interest in the collateral."

Ultimately, Carolina leased the trucks to a third-party user, Oklahoma Southern Transportation Inc. Oklahoma Southern took possession of the trucks, and Carolina received the manufacturer's statements of origin (the "MSOs"). The MSOs identified Carolina as the lessor, Oklahoma Southern as the lessee, and U.S. Bancorp as the lienholder. According to U.S. Bancorp, it was the responsibility of Oklahoma Southern to title and license the trucks. However, Oklahoma Southern failed to do so, and U.S. Bancorp's interest in the trucks never became perfected.

In 2000, Oklahoma Southern filed for Chapter 11 bankruptcy. Because U.S. Bancorp's security interest was not perfected, the trucks became the property of the bankruptcy estate and Oklahoma Southern stopped paying on the lease to Carolina. Nevertheless, North American, was still obligated to pay on its lease to U.S. Bancorp. In 2001, Carolina, which was deemed an unsecured creditor, settled with the bankruptcy trustee and paid \$25,000 for the release of the trucks.



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Rush, North American and Carolina brought suit against U.S. Bancorp, asserting that the bank had a duty under the parties' contractual agreements to ensure that U.S. Bancorp's security interest was properly perfected. According to the plaintiffs, had U.S. Bancorp properly perfected its security interest, the plaintiffs would have been able to immediately repossess the trucks or have them released from the bankruptcy estate. Therefore, the plaintiffs asserted, because U.S. Bancorp failed to ensure that the security interest in the trucks was properly perfected, the plaintiffs suffered financial losses. U.S. Bancorp moved for summary judgment, which was granted. The plaintiffs appealed.

The plaintiffs asserted that the "warranty" clause of the security agreement imposed a duty on U.S. Bancorp to perfect its security interest in the trucks. The Supreme Court of North Dakota disagreed. It said that it saw nothing in the language of the security agreement or power of attorney clause that imposed an affirmative duty on the bank to perfect. In fact, the Court saw just the opposite. The Court said that the language of the security agreement imposed a duty on the debtor to assist the creditor in the creditor's effort to perfect, if the creditor so desired. Further, the high court said the power of attorney clause gave the bank the "authority" to do certain things to perfect its security interest, but did not impose any duty on the bank to perfect.

An additional argument from the plaintiffs included the maxim expression unius est exclusion alterius, which means "the expression of one thing is the exclusion of another," i.e. that because the security agreement did not state that Carolina was obligated to perfect U.S. Bancorp's security interest, it was U.S. Bancorp's duty. Furthermore, the plaintiffs claimed that the agreement itself was ambiguous and that it should have been construed against U.S. Bancorp which prepared the document and should have drafted it to ensure that U.S. Bancorp's security interest would be perfected. Nonetheless, the Court declined to impose upon U.S. Bancorp a duty to perfect and affirmed the trial court's decision in favor of the bank.

While the lender was not held liable to third parties for failure to perfect its security interest, it is important to remember that failure to do so will impact the lender's ability to collect its loan, especially if a bankruptcy or intervening creditors are involved.

This case is cited as *Rush, et al. v. U.S. Bancorp Equipment Finance, Inc.*, 742 N.W.2d 266, 2007 SD 119, S.D., November 14, 2007 (NO. 24387).

## OUR SERVICES

Providing lenders with only the highest and most knowledgeable levels of lending counsel in all phases of commercial lending transactions.

Representing both borrowers and lenders in complex real estate and development transactions.

Advising and counseling in the structuring, documenting and closing of asset-based loans, and in the perfection of the lender's security interest.

Providing counsel to bank and non-bank lenders in closing government guaranteed loans under the 7(a), 504, B&I and "piggyback" loan programs.

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## Court Rejects Mutual Mistake Defense

**A U.S. DISTRICT COURT IN TEXAS FOUND THAT GUARANTORS COULD NOT REFORM THEIR GUARANTIES UNDER THE DOCTRINE OF "MUTUAL MISTAKE" WHEN THERE WAS NO EVIDENCE THAT THE GUARANTIES DID NOT REFLECT THE LENDER'S INTENT AND MUTUAL MISTAKE CAN EXIST ONLY IF A DOCUMENT CONTRADICTS THE INTENT OF ALL PARTIES INVOLVED.**

In 2004, Medical Plaza Surgical Center, LLP was formed, composed of one managing partner, LifeCare ASC Management, L.L.C.; and seven other partners. LifeCare did not make an initial capital contribution but received a 15% ownership interest in the partnership. The 15% ownership interest was held equally by Clifford Kirby and Melinda Andress. The other seven partners held the remaining 85% of the interest in LifeCare and each committed to purchasing between 2 and 4 units in the

necessary resources to deal constructively with problem loans and the implementation of creative loan work-out arrangements.

## PRACTICE AREAS

**Business and Taxation**

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partnership at \$15,000 per unit. In 2004 and 2005 Whitney National Bank made 3 loans to Medical Plaza Surgical Center, LLP, which totaled over \$1,395,000. Medical Plaza's managers and doctors signed guaranties for 150% of the debt to Whitney, as was reflected in the first and second notes. Kirby and Andress each guaranteed 150% of LifeCare's 15% ownership interest, while the other seven doctors and/or partners each guaranteed up to 150% of their respective ownership interests. Each guaranty provided "The principal amount of this Guaranty is [X] percent of all amounts due now or later from the Borrower to the Lender as provided below, however in no event to exceed [Y] dollars (\$[Y])." The X figure was each partner's percentage interest, whereas the Y figure was based on 150% of each partner's ownership interest as stated in the June 2004 ownership list presented to Whitney. The third promissory note was guaranteed by all partners except Dr. LaMarra and Dr. Mann in the amount of \$21,500 by each other partners. In April 2006 Whitney notified Medical Plaza and the guarantors that the notes were unpaid and demanded payment. Medical Plaza did not make payment and Whitney filed suit against Medical Plaza and the guarantors.

Three of the guarantors, LaMarra, Bui and Guajardo, asserted a defense of mutual mistake. They stated that although they signed agreements guaranteeing 150% of debt based on a pro-rata portion of their ownership interest as shown in the June 2004 ownership list, that is not what the parties intended. They contended that the parties intended the guaranties be limited to 105% of a pro rata portion of the debt based upon their actual ownership interest in Medical Plaza from time to time and that the partners did not in fact purchase the interests that were contemplated as set forth in the June 2004 ownership list. Whitney argued that the percentages to be used were those set forth at the beginning of the relationship in the June 2004 ownership list and there was no evidence to support the argument that the guaranty amounts were to fluctuate over time to reflect actual contributions.

Under Texas law, "when parties to an agreement have contracts under a mutual misconception of material fact, the agreement is voidable under the doctrine of mutual mistake." The moving party must prove that there exists: 1) a mistake of fact, 2) held mutually by the parties, 3) which materially affects the agreed upon exchange." The Court found that in this case, there was insufficient evidence to create a fact issue. The Court noted that Whitney presented competent evidence that it intended the maximum liability to be fixed based on the partnership ownership interest as reflected in June 2004 list. The Court found no evidence that Whitney intended the percentages to fluctuate and noted that the written documentation supported Whitney's argument. Additionally, the Court noted that if the maximum amount was to be adjusted as the defendants sought, 150% of the total debt to Whitney would not be guaranteed at 150%. Finally, the Court noted that in a very similar case the same defendants raised the same defense and the Texas court had already rejected the argument.

Guaranty Agreements are an important portion of a loan package. In many instances, the guaranty is not for simply 100% of the loan amount, but may be unlimited or for some variable value. Properly drafted guaranty agreements spell out the exact nature of the guaranty and protect the lender in cases of default. A well-documented guaranty, as well as careful drafting of all loan documents, supported by an accurate loan file, should withstand the defense of mutual mistake.

The case is cited as *Whitney National Bank v. Medical Plaza Surgical Center LLP*, 2007 U.S. Dist. LEXIS 79145 (S.D. Tex. Oct. 25, 2007)



### Seminar Alert!

Please join us for the following seminars:

**Strategies For Lenders & Business Owners When Fundamental Changes Occur**, scheduled for October 28th at 7:45AM in our offices. Art Lafionatis and Ray Sherbill will discuss:

1. Bankruptcy, Death or Disability of Members, Partners, Officers And Managers
2. Asset vs. Stock Sales And Their Impact On Owners And Lenders
3. Owner And Investor Loans, Subordination And Intercreditor Agreements

**How To Collect The SBA Guarantee**, scheduled for November 20th at 7:45AM in our offices. Alison Rind and Arnie Spevack will discuss:

1. Tips On Minimizing The Likelihood That The SBA Will Reject Your Bank's Guarantee Repurchase Request
2. What Lenders Need To Know About The SBA Repurchase Process To Ensure Timely Payment Of The SBA Guarantee

Please contact Bill Melchior at [wgmelchior@lercheearly.com](mailto:wgmelchior@lercheearly.com) to register.

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### Thank You

Thank you to all of our lender clients who sponsored the Montgomery County Bar Foundation Annual Golf & Tennis Outing held at Argyle Country Club on October 13, 2008. With your assistance we raised over \$28,000 for the Montgomery County Bar Foundation Pro Bono services.

Alison W. Rind  
Co-Chairperson

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### We Would Like To Hear From You

We publish this newsletter as a service to our clients as a means to make them aware of certain aspects of the law. As always, we would like to hear feedback from our readers regarding the content of the newsletter. If there are items or topics you would like to see covered in future issues, or you have a suggestion concerning the newsletter itself, you may send them to Bill Melchior at [wgmelchior@lercheearly.com](mailto:wgmelchior@lercheearly.com).

Additionally, a number of the Firm's other departments periodically issue highly informative newsletters on a variety of other subjects, including Real Estate, Community Associations, and Employment and Labor. If you would like to view one or more of these newsletters, you may access them through our website, [www.lercheearly.com](http://www.lercheearly.com).

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