LERCH EARLY & BREWER

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Welcome to the *Commercial Lending Bulletin*, a monthly newsletter published 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.

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TARP Does Not Create A Private Right of Action Against Fund Recipients

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In 2006 and 2007, Homes By Williamscraft, Inc. and B. Wilmont Williams entered into loan agreements with Regions Bank to finance the construction of residential properties. Regions received security deeds granting ownership of the homes to Regions until each property was sold and the associated portion of the loan was paid off.

When the housing market declined in 2008, Williamscraft was unable to sell enough homes and fell

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behind on its monthly payment obligations to Regions.

In January 2009, Regions sued Williamscraft alleging that the company was in default. Williamscraft counterclaimed, alleging, among other things, that Regions violated its duties under TARP by failing to modify the loan.

In October 2008, Congress passed the Emergency Economic Stabilization Act to address the subprime mortgage crisis. This led to Congress' creation of the Troubled Asset Relief Program, commonly referred to as TARP. TARP authorized the U.S. Treasury Department to spend $700 billion to purchase assets and equity from financial institutions to stabilize domestic financial markets. As part of the implementation of TARP, the U.S. Treasury Department used TARP funds to purchase an interest in Regions Financial Corporation, an entity related to Regions.

Williamscraft argued that TARP created a private right of action against fund recipients (such as Regions) that breached their duties under the act by opting to foreclose upon, rather than modify, existing delinquent loans, particularly when doing so was not in the best interest of the taxpayer and the bank.

Contrary to Williamscraft's assertion, the U.S. District Court, Northern District of Georgia, ruled that TARP did not authorize borrowers to sue lenders. In the absence of express statutory authority, the Court said it would find a private right of action only if there was affirmative evidence of Congressional intent. The Court found no such intent, noting that 12 U.S.C. § 5229, which expressly addresses judicial review under TARP, does not mention a private right of action against fund recipients or other nongovernmental entities. In addition, the Court explained that the existence of other remedies in Section 5229 is sufficient under Federal common law to imply a lack of Congressional intent to allow private actions against fund recipients.

This case is cited as *Regions Bank v Homes by Williamscroft, Inc.* 2009 WL 3753585 (N.D. Ga 11/16/09).

Lender Benefits from Confirmed Bankruptcy Plan Even Though Debtor Later Dismisses Bankruptcy Suit

Many lenders assume that when a borrower enters bankruptcy lenders lose control of the repayment process. However, in many instances, they can leverage their liens and claims to help negotiate a confirmed plan with a borrower in bankruptcy to repay the debt.

A U.S. Appellate Court held that a confirmed plan under a Chapter 12 bankruptcy action was enforceable even though the bankruptcy action was dismissed later by the debtors.

Walter and Carla Wiese were dairy farmers who borrowed money from Community Bank of Central Wisconsin to expand their business. The Wieses defaulted on the loan and the Bank commenced foreclosure and recovery actions on the collateral held by the Bank. The Wieses filed a Chapter 12 bankruptcy, a voluntary type of bankruptcy specifically designed for family farmers. As part of the Wieses' confirmed plan of bankruptcy, the Wieses and the Bank made certain concessions, one of which required the Wieses to release their purported "lender liability" claims against the Bank, arising from the Bank's advice in connection with the loan and construction of their barn. The Wieses later decided to have the bankruptcy case dismissed. Though the Wieses had a statutory right to dismiss the bankruptcy, the court determined there was "cause" for the terms of the confirmed plan to remain binding on the parties.

The confirmed plan included the following terms: the Wieses agreed to release the lender liability claims against the Bank; and the Bank agreed to: i) release a lien on funds held in escrow, ii) forgive default interest, iii) set a cap on attorneys' fees and out of pocket expenses, iv) allow a four-month delay prior to recommencing payments and v) recalculate the Wieses' loan at the contract rate of interest rather than at the higher default rate. Less than a week after the plan's confirmation, the Wieses filed a motion

to vacate the confirmed order and liquidate their assets because a loan program for financing that they thought would be available to them was not.

The appellate court reviewed the case, the parties' negotiations and the concessions granted by the Bank to determine whether there was "cause" for the parties to continue to be bound by the plan. The appellate court found that the Wieses needed the Bank's consent to confirm the plan and the Bank had an interest in obtaining a release of the lender liability claims. The Wieses induced the Bank to consent to the plan by including the release and the Wieses got what they bargained for – a confirmed plan. After confirmation of the plan, the money in escrow was released to the Wieses and the Bank lost its ability to collect it. The Bank agreed to give up the lien "in reliance on the bankruptcy case" and when the Wieses decided to dismiss the case, it was appropriate for the bankruptcy court to consider the harm that dismissal caused to the Bank. Therefore, the court found that the terms of the confirmed plan remained in effect, including the release of the lender liability claims, even though the Chapter 12 bankruptcy had been dismissed.

The case above is cited as *In re Wiese,* 51 BCD 12 (7th Cir. 2009).

Lender's Misrepresentations Lead to Fraud Claim by Purchaser of Note

When selling loans in the secondary market, lenders should be careful in their representations and warranties regarding a particular loan. It is best to allow an investor to make its own investigation without independent representations by the lender about the strength of the loan or the borrower.

Recently, the U.S. District Court for the Eastern District of Virginia determined that an investment company that purchased part of a U.S. government-guaranteed loan could proceed in its claim of fraud against the lender who misrepresented the strength of the borrower and the loan.

In January 2008, Beach First National Bank loaned $3 million to Fried Okra, Inc., owner and operator of a popular restaurant in Myrtle Beach, South Carolina. Eighty percent of the loan was guaranteed by the U.S. Department of Agriculture through its Business and Industry Guaranteed Loan Program, which is designed to stimulate rural economies.

Plaintiff Solomon Hess SBA Management LLC purchases existing loans guaranteed through such government programs by paying a premium to the selling lender. In July 2008, Hess learned that Beach would consider selling some of its portfolio of government-backed loans and contacted Beach vice president Johnny Brown. Brown assured Hess that Beach's government-backed loans were performing well and specifically stated that the Okra loan was "good solid credit." Brown further provided a letter of attestation regarding the Okra loan that stated that Beach had no knowledge of a default in the loan and no "information indicating an increased likelihood of default" or prepayment of the loan.

After receiving these assurances, Hess purchased two-thirds of the guaranteed portion of the loan and paid Beach a premium of more than $99,000. Less than two months later, Okra stopped making loan payments and sold the restaurant. Hess sued Beach for fraud, asking for judgment in excess of $100,000, punitive damages and costs. Beach filed a motion to dismiss.

In support of its motion to dismiss, Beach first claimed that Hess could not assert a fraud claim when the parties had "memorialized their business agreement in a contract." However, the court found that Virginia law allows for a separate fraud tort despite the presence of a contract, and that such a claim may be found if Hess had purchased the loan based solely on assurances from Beach that turned out to be false. In Virginia, a claim for fraud must allege "i) a false representation, ii) of a material fact, iii) made intentionally and knowingly, iv) with intent to mislead, v) reliance by the party misled, and vi) resulting damage to the party misled." The main issues in this case were whether statements made by Beach were opinions or misrepresentations of fact and whether Hess had actually relied upon Beach's statements.

While the court agreed that some of Beach's statements had been opinion or predictions which could not

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form the basis of a fraud claim, it refused to find that the letter of attestation contained only non-actionable opinions or predictions. The court stated that some of the information contained in the letter of attestation could constitute actionable fraud, particularly the statement of fact that no one at Beach had "any information indicating an increased likelihood of a default by Borrower."

Further, the court found that this statement could have been knowingly false, because Hess alleged that Beach was aware of the following factors indicating Okra was suffering financial difficulties: i) a factoring loan obtained by Okra in which 35% of its income was garnished, ii) Okra's inability to repay a prior loan made to it by Beach, iii) late payments made by Okra in the government-guaranteed loan and iv) information relating to Okra's increasing financial distress. Obligated to accept these allegations as true at this point in the litigation, the court found that Hess had sufficiently pled this element of fraud. In addition, the court found that Hess had sufficiently pled that the claimed misrepresentations were material, because knowledge of these factors could have prevented Hess from purchasing the loan.

Beach also objected to Hess's claimed reliance upon Beach's representations on grounds that Hess failed to make its own investigation into the potential risks involved in purchasing the loan. Beach pointed out that Hess had not alleged that Beach had acted to conceal Okra's financial condition or to discourage Hess from investigating Okra and claimed that "any representations it may have made were too vague and indefinite to induce reasonable reliance." However, the court found that Beach's statements "may have diverted Hess from making further inquiry or inspection," and stated that "statements of fact that relate to the 'present quality or character' of the product at issue may induce reasonable reliance."

This case is cited as *Solomon Hess LLC v. Beach First National Bank*, 2009 WL 2045944 (E.D.Va.).

Tip of the Month: Consider Requiring a Mutual Waiver of Subrogation to Limit Borrower Liability

Subrogation is a legal principle that one who makes another party whole following a loss (usually related to an insurance policy or indemnification agreement) obtains the legal rights the indemnified party had, if any, to proceed against the party who caused the loss. Thus, subrogation enables an insurance company that reimburses its insured in the event of a loss to "step into the shoes" of the insured with respect to the insured's rights against a third party that negligently or deliberately caused the loss. Subrogation derives from basic concepts of equity: i) the insured party should not be entitled to a windfall by recovering a second time by suing the party responsible for the loss and ii) the third party should not relieved of liability merely because the loss was insured.

An insurance company's right of subrogation can be eliminated by including waiver of subrogation language in the operative documents (a lease for example) and in the insurance policy. Such a waiver is typically a mutual waiver applicable to losses caused by the tenant or the borrower/landlord, and usually is limited to damage or loss due to fire or other casualty. From a lender's perspective, a mutual waiver of subrogation is beneficial in that it ultimately helps to protect the lender's investment in the borrower by shielding the borrower from liability from the tenant's insurance company and protects the tenant from liability from the landlord's insurance company. Thus neither the borrower nor its source of repayment of the loan, i.e., the tenant, are liable to the insurance company for a negligent act.

Because an impermissible waiver of subrogation can void an insurance policy, it is important to be sure that the waiver of subrogation does not violate the terms of the insurance policy, or, if prohibited by the insurance policy, that a waiver of subrogation by endorsement to the insurance policy is obtained. The loan documents can be drafted to require that the borrower obtain a waiver of subrogation endorsement from its insurance company and the tenant's insurance company, if applicable.

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