

LENDER LIABILITY IN CONSTRUCTION AND REAL ESTATE FINANCING

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It has been said that the love of money is the root of all evil. The want of money is so quite as truly.”¹

I. INTRODUCTION

Economic prosperity and industry booms do little to portray the extent to which individuals and corporations reach in order to protect their financial interests. It is during economic hardships and recessions, periods such as the one we are currently going through, when the true colors of contracting parties in financing agreements are revealed.

As Puerto Rico’s economy continues to deteriorate, and the real estate industry along with it, we may expect continuous foreclosures and frequent litigations in the near future regarding defaulted construction loans. Along with these foreclosures will come numerous defensive arguments, on behalf of borrowers, who will do anything to avoid the onerous results of foreclosures and the subsequent execution of personal guarantees that comes with them. One of these arguments, Lender Liability, will be discussed and developed in this article through the examination of treatises, jurisprudence, and actual situations which I myself have had the opportunity to witness. Predominantly, I wish to examine cases under which courts

¹ SAMUEL BUTLER, EREWHON, 179 (1872).

sustain the lender liability argument and *what* are the remedies granted to the prevailing party, with particular focus on construction loan agreements.

Unsurprisingly, lender liability gained prominence and acceptance as a substantive body of law during the early 1980's,² at which time the United States was also experiencing a deep recession. Lender liability law basically consists of the principle that lenders must treat their borrowers fairly and, in those instances in which they do not, they can be subject to borrower litigation under a variety of legal claims.³ Indications of potential lender liability include inordinate lender control, atypical lending practices, lack of professionalism, abuse of a special relationship, and conflicts of interest. Lender liability theories often permit a plaintiff to go beyond the *four corners* of loan documents. According to Edward F. Mannino:

Awards in recent lender liability suits have been obtained on a wide range of theories – tort, contract, and statutory, some new and some old. Breach of contract, fraud, misrepresentation, duress, control, and intentional infliction of emotional distress are each settled common law doctrines, which are now being applied to lender liability cases, while bad faith, breach of fiduciary duty, and joint venture are new or evolving common law doctrines of lender liability. Statutory requirement, including those set forth in RICO, CERCLA, federal tax, and federal securities laws, also supply additional theories of lender liability.⁴

Throughout this article, the different theories under which lender liability awards have been obtained and which may apply to construction financing agreements will be discussed in further detail.

As it pertains to Puerto Rico and its jurisprudence, although the doctrine of lender liability, as such, has not been the direct target of scrutiny, the local Supreme Court has had more than enough opportunities to examine most of the theories under which lender liability claims have been upheld. Namely, Puerto Rico's Supreme Court has thoroughly examined the theories of breach of contract, fraud, misrepresentations, estoppel, good faith requirements, and excessive control by lenders. We should expect some new local jurisprudence in the next few years with regards to these topics and how they pertain to real estate financing, as there are currently dozens of large foreclosure suits and borrower counterclaims either in the District Court or in the Court of Appeals. Nevertheless, given the lack of substantive

² Cappello & Noël, LLP, *What is Lender Liability?* (1999), available at http://www.cappellonoel.com/news_articles/what_is_lender_liability.html.

³ *Id.*

⁴ Edward F. Mannino, *New Developments in Lender Liability: Theories of Lender Liability Litigation*, 1993 A.B.A. SEC. BUS. L. 3.

jurisprudence concerning the specific issue of lender liability from the local courts, with some exceptions, most of the jurisprudence referenced to within these pages originate in the U.S.' federal and state courts.

II. LENDER LIABILITY ARGUMENTS – CONTRACT THEORIES

Most lender liability causes of action arise from either contract or tort theories. Hence, the focus of this piece will begin by examining the lender liability arguments arising from contract theories and will later turn to those arguments based on tort theories.

In Puerto Rico, contractual obligations are, for the most part, governed by the Civil Code, which, among other things, states in Art. 1230 that "Contracts shall be binding, whatever may be the form in which they may have been executed, provided the essential conditions required for their validity exist."⁵ Furthermore, Art. 1213 of the Civil Code utters the essential conditions for a contract to be valid, which are: consent, object and cause.⁶ But for the type of contract that will be discussed throughout this section, the construction or real estate financing agreement, it is important to highlight the fact that Art. 1232 of the Civil Code states that contracts must be in written form, in order to be enforceable, if the object or service originating the agreement is worth more than \$300.⁷ Thus, it would be difficult for either a borrower or lender, in our jurisdiction, to enforce an oral agreement for a construction or real estate loan.

"Lender contractual liability is usually based on one of the following concepts: anticipatory repudiation, promissory estoppel, condition precedent, acceleration, duty to inspect, and breach of good faith."⁸ It is very important to note that courts will generally enforce contracts as written, thus:

Bank[s] have the right to insist that a borrower comply with the provisions of the contract, which is embodied in the various loan documents executed in connection with any loan or financing transaction. Such insistence cannot constitute, or give rise to, a claim by the borrower of breach of contract by the lender.⁹

A. Anticipatory Repudiation

⁵ P.R. LAWS ANN. tit. 31, § 3451 (2007).

⁶ P.R. LAWS ANN. tit. 31, § 3391 (2007).

⁷ P.R. LAWS ANN. tit. 31, § 3452 (2007).

⁸ Roy Ryden Anderson and Diane K. Lettelleir, *Contracts Theories, in 1 Lender Liability Law and Litigation* § 3-36 (2009).

⁹ *Id.*

Anticipatory repudiation occurs when a promisor (lender) without justification and before any breach has been committed by the promisor unequivocally indicates by statement to the promisee (borrower) or by the promisor's conduct that the promisor is no longer willing or able to substantially perform its contractual obligations. The repudiating statement or conduct must be positive and unequivocal; a mere implication of repudiation is not sufficient.¹⁰

For a borrower to recover on a theory of anticipatory repudiation, the following elements must be established: 1) that the lender made a loan commitment to the borrower; 2) that the lender withdrew the commitment before the expiration of the time allotted to the borrower to comply with the required conditions, or the lender insisted that the borrower perform conditions not contained in the original commitment agreement; 3) that the borrower was damaged as a result of the withdrawal of the commitment.¹¹

The question under the anticipatory repudiation principle would then be: may a lender, who has objective reason to believe that the borrower will not be able to repay the debt incurred under a construction financing commitment, withdraw its commitment to fund the project without exposing itself to lender liability? For instance, if the borrower has experienced long delays in beginning the project and, as a result, will also suffer significant cost overruns, may the lender withdraw its commitment to fund, knowing that the project will be out of budget? Or, if an in depth market analysis performed by a third party shows that a construction project, as originally proposed, is no longer feasible, may the lender refuse to continue funding the project without exposing itself to a lender liability claim? The answer to these questions seems to be "yes".

Courts have repeatedly allowed banks to withdraw their commitments under circumstances such as the ones described above. However, they usually place the burden of proof on the bank to show that the borrower would have been unable to meet the required conditions of the financing agreement. For instance, a bank would have to show that conditions of a construction loan agreement, such as an *in balance* provision, would not be able to be fulfilled because the construction project has had numerous setbacks, change orders or delays, or simply establish, with a preponderance of the evidence, that the budget of the project has been significantly altered.

¹⁰ *Id.* at 3-38 (citations omitted).

¹¹ *Id.*

In *Glatt v. Bank of Kirkwood Plaza*,¹² the Bank committed \$1.7 million to finance the plaintiff's project which involved the purchase of condominiums and the construction of a restaurant, bar and racquetball club. Prior to the commitment's expiration, the bank withdrew its commitment and took definite action to repudiate the agreement, arguing that "racquetballs and the recreation facilities in the areas are not successful", and that "the loan was not a workable loan."¹³ The court ruled in favor of the developers on the issue of anticipatory repudiation and placed the burden of proof on the bank saying, "but in terms of trying to establish whether or not they [the developers] could have met those conditions, it would not be a matter then of them proving they could have, but a matter of you [the Bank] proving that they could not."¹⁴ Despite this ruling and the assertions made by the court in this case, a bank should be successful in its defense of the anticipatory repudiation claim provided it can, as a matter of fact, establish the inability of the borrower to meet the conditions set forth in the loan agreement, including repaying the loan.

In practice, many borrowers use the anticipatory repudiation argument when establishing a counterclaim against the lenders. Their main argument is that, by repudiating the contract prematurely, the lender did not give the borrower, or the project, a chance to succeed. In other words, they argue that by repudiating the contract the lender set up the borrower, or the project, to fail. It remains to be seen if local courts will give way to those arguments and what, if any, will be the remedy awarded to the grieving party. Nonetheless, even if the courts do not accept this argument, these counterclaims will at least buy the borrower some time, avoid summary judgments in favor of the lender and postpone the foreclosure and execution of the personal guarantees.

According to authors Roy Ryden and Diane Lettelleir, damages for anticipatory repudiation can be extremely large.¹⁵ As an example, the authors cite *Federal Deposit Insurance Corp. v. Scharenberg*, which arises from a construction loan default. In said case:

Although the borrower had complied with all loan conditions, the lender declared the loan to be in default and turned the loan over to the FDIC. [The lender alleged] that the borrower would have been unable to meet certain conditions. The FDIC sued the borrower for this alleged default and recovered a \$55 million judgment. A week

¹² *Glatt v. Bank of Kirkwood Plaza*, 383 N.W. 2d 473 (N.D. 1986) (citation omitted).

¹³ *Id.* at 475.

¹⁴ *Id.*

¹⁵ Anderson & Lettelleir, *supra* note 8, at 3-40.

later, the borrower won a \$105 million jury verdict against the lender for breaching the loan contract.¹⁶

Legal counsel for financial institutions should pay plenty of attention to the language included in commitment letters and financing agreements with regards to the obligation of lenders. The language of said documents should contain as many exceptions or *ways out* of the contract for the lender as possible. For commitment letters a good practice is to set a very short-term expiration date. Thus, if the borrower takes his time in reviewing the terms of the commitment letter and does not accept it before the expiration date, the lender may revisit his decision or may simply change some of the terms originally included in the letter, without the risk of anticipatory repudiation liability. For financing agreements a good practice is to include *in balance* provisions. These provisions usually state that the project's budget must be *in balance* at all times. If there is a cost overrun or a change order, the covenant states that the borrower must make a capital contribution in order to reestablish the balance in the budget. Failure to do this gives the lender the right to declare the default and repudiate the contract. Moreover, another good practice for construction loan contracts is to establish deadlines for construction termination. Therefore, if the borrower suffers delays in the beginning of construction and it can be proven, as a matter of fact, that he will not be able to comply with the construction termination date, the lender may once again declare the default and repudiate the contract.

B. Promissory Estoppel and Negligent Misrepresentation

Even though the lender has not made a binding loan commitment, liability may attach for promises made by the lender during the loan negotiation process. If the proposed borrower (the promisee) has reasonably acted to its detriment in reliance upon such promises, it may have a successful action against the lender (the promisor) under the doctrine of promissory estoppel.¹⁷

The Court explained this doctrine in *Consolidated Services, Inc. v. Keybank National Association* stating that it is, “[a] doctrine of contract law, its purpose is to enforce promises that while not supported by consideration, and so not enforceable under traditional principles of Anglo-American

¹⁶ *Id.* at 3-41.

¹⁷ *Id.* at 3-42.

contract law, were likely to induce and did induce reliance by the promisee.”¹⁸ As explained by the author, “promissory estoppel does not create a contract that otherwise did not exist, but only prevents a party from insisting upon his strict legal rights when it would be unjust to allow him to enforce them.”¹⁹

In *MSA Tubular Products, Inc. v. First Bank and Trust Co.*, the court expresses the following in relation to lender liability cases involving promissory estoppel and negligent misrepresentation:

In order to recover, a plaintiff . . . must allege and prove by a preponderance of the evidence: (a) A misrepresentation or omission of a fact; (b) That the representation or omission is material or significant; (c) That in responding to the credit inquiry the bank officer failed to exercise that degree of diligence and expertise the public is entitled to expect of reasonably competent bank officers; (d) That it reasonably relied upon the bank's misrepresentation or omission; and (e) That it suffered damages as a direct and proximate result of such reasonable reliance.²⁰

Even though in Puerto Rico contracts that involve a sum that exceeds \$300 must be in writing, the Supreme Court in cases such as *Int. General Electric v. Concrete Builders*²¹ has admitted the promissory estoppel argument, or what it calls *self acts doctrine*, to enforce obligations between non-contracting parties. Thus, the question which arises from the theory of promissory estoppel is: does a borrower have a cause of action, under the promissory estoppel theory, when he acts relying on a credit officer's oral statements that a construction loan has been approved or that the loan will be forthcoming subject to the performance of certain conditions? Can a prospective borrower enforce an oral promise to lend?

In cases based on theories of negligent misrepresentation or promissory estoppel, courts in a number of jurisdictions have answered affirmatively to these questions in several recent decisions, some resulting in multimillion-dollar awards. Other courts have disagreed with the approach taken in these decisions.²² Thus, it seems that the potential results in our jurisdiction, for situations based on these theories, will have to be evaluated on a case-by-case basis. The Supreme Court's ruling will probably be

¹⁸ Consolidated Services, Inc. v. Keybank National Association, 185 F.3d 817, 822 (Ind. 1999).

¹⁹ Anderson & Lettelier, *supra* note 8, at 3-43 (citations omitted).

²⁰ MSA Tubular Products, Inc. v. First Bank and Trust Co., 869 F.2d 1422, 1424 (Okl. 1989).

²¹ Int. General Electric v. Concrete Builders, 104 D.P.R. 871 (1976).

²² Mannino, *supra* note 4.

determined by the particular facts of the case, the precedent that the court wishes to establish, and the protection that the court wants to grant either to borrowers or to lenders.

As a matter of example, in *Rhode Island Hospital Trust National Bank v. Varadian*, the court reversed a verdict in excess of \$4,000,000 in favor of borrowers, based on promissory estoppel theory, where bank personnel orally promised to provide borrowers a construction loan of \$43,500,000. The court found such promise was not a commitment because “the bank made an oral *promise* which the bank did not intend, and the defendants did not understand, to be a commitment because both parties contemplated a written agreement that would govern the intricacies of the \$43,500,000 construction loan.”²³ The court concluded that “because the evidence in this case did not warrant a finding that a *promise* in the contractual sense had been made, any reliance by the defendants (borrowers), who were experienced businessmen, would be unreasonable as a matter of law.”²⁴

On the other hand, in *Federal Land Bank Association v. Sloane*,²⁵ a loan officer informed the borrower that the bank's board had approved the loan, and that the borrower could go ahead with site preparation work. The contractor hired by the borrower to build the new chicken houses contacted the bank's loan officer to see if he should begin construction, notwithstanding the pending nature of the loan. The loan officer said that there was “no problem, and that there was not any reason for them not to continue at that point.” The borrower had one of their old chicken houses demolished, and paid approximately \$9,000 for further site preparation. Later, the borrower received a letter from the bank denying their loan application, giving as reasons for the denial the fact that they failed to include two outstanding debts on their application and that they incurred in additional liability for a car purchase while the loan was being processed. The borrower then sued the bank alleging that the loan officer had negligently misrepresented that their loan application would be approved. The court ruled in favor of the borrower based on the facts that: (1) the representation was made by the lender in the course of his business, or in a transaction in which he has a pecuniary interest; (2) the lender supplied “false information” for the guidance of others in their business; (3) the lender did not exercise reasonable care or competence in obtaining or communicating the information; and (4) the plaintiff suffered pecuniary loss by justifiably relying on the representation.

These two examples show how courts are still fairly inconsistent in their rulings of cases based on promissory estoppel and negligent

²³ R.I. Hosp. Trust Nat'l Bank v. Varadian, 419 Mass. 841, 850 (1995).

²⁴ *Id.*

²⁵ Federal Land Bank Association v. Sloane, 825 S.W. 2d 439 (Tex. 1991).

misrepresentation. One thing is certain, however, and it is that courts usually deny recovery for lost expectation damages and limit recovery solely to reliance damages. For instance, in *Wheeler v. White*,²⁶

the court made clear that damages based upon expected profits should not be allowed even though such a loss could be proved with certainty. The court stated that any recovery must be limited to damages based upon the detriment sustained by Wheeler [the borrower] in reliance upon White's [the lender's] promise that the loan would be forthcoming.²⁷

In Puerto Rico, lenders are litigating cases with a factual background similar to *Federal Land Bank Association v. Sloane* arduously. The cases, which focus in negligent misrepresentation and estoppel, are being litigated in local courts and focus on contractors and third party suppliers, rather than on the borrower. These third parties constantly argue that they relied on the loan officers' and lender's representations when they begin to work on the borrower's project. Often the result of this action is that, if the project is unsuccessful, the third parties could end up not getting paid for the work already done. Also, another scenario is that the developer ends of owing the reitenance to these third parties. At this stage the third parties usually look to the lender in order to satisfy their claim.

The problem that these third parties face, when making their claims to the lenders is that, in the majority of the cases, they have no solid evidence to prove that the lenders are liable to them. Given the absence of any contractual relationship between the bank and the third party contractor, their argument lacks merit. Nonetheless, it was a usual practice for the lenders a few years ago to issue a simple letter to the contractors stating that a given amount of dollars had been approved, for use by the borrower, to pay for work performed by that contractor. When the borrower, for whatever reason, fail to make payment to that contractor, those third parties always include the bank in their collection lawsuits. It remains to be seen what the local courts will decide in those particular cases. Nevertheless, those letters issued by the bank certainly qualify for a solid estoppel or negligent misrepresentation argument.

²⁶ *Wheeler v. White*, 398 S.W. 2d 93 (Tex. 1965).

²⁷ *Anderson & Lettelleir*, *supra* note 8, at 3-45.

C. Conditions Precedent – Lender Satisfaction

As a condition precedent, lenders occasionally require that the borrower perform certain tasks to the individual satisfaction of the lender. The general rule is that such conditions require only good faith satisfaction of the lender. Some courts have stated that without this good faith requirement, an agreement conditional upon one party's satisfaction would be illusory and would cause the entire contract to fail under the basic contract doctrine of mutuality of obligation.²⁸

One question quickly jumps to mind under this topic of lender satisfaction: may a lender refuse to honor a commitment to lend because the bank's lending policy has not been performed by the borrower to the individual lender satisfaction? Authors Roy Ryden and Diane Lettelleir provide the example of *First Texas Savings Association of Dallas v. Dicker Center, Inc.*,²⁹ in which a "loan commitment for \$2 million was conditioned upon receipt by the lender of a satisfactory appraisal of the property after improvement."³⁰ In said case,

the bank[s] policy was to advance not more than 75 percent of the appraised value of the property. Even though the borrower submitted two appraisals, it was unable to meet this 75 percent requirement. Accordingly, the lender refused to make the loan, contending that the appraisal condition had not been satisfactorily met.

The court found that the only issue raised was whether the lender's refusal had been made in good faith. The record showed that the 75 percent ratio of loan to land value was standard for the industry in the lender's area. . . [T]he court concluded that the lender's decision not to fund the loan was made in good faith.³¹

What if the conditions for approval of the loan commitment are established in such a way that the bank knows that the borrower will not be able to perform them to the individual satisfaction of the lender? For instance, it is not uncommon to see a lender establishing as a condition for granting a loan commitment that the borrower must make a capital

²⁸ *Id.* at 3-51, 3-52 (citations omitted).

²⁹ *First Texas Savings Association of Dallas v. Dicker Center, Inc.*, 631 S.W. 2d 179 (1982).

³⁰ *Anderson & Lettelleir, supra* note 8, at 3-52.

³¹ *Id.*

contribution of 25 percent of the total costs of a construction project, knowing that the borrower does not possess such capital. The practice among developers is to offer the bank with what they call *deferred equity contributions*, which consist mainly of the contractor's retainage, the sales and marketing costs, and municipal taxes and patents. May a bank refuse this sort of equity contribution and demand *cash equity* based upon an individual lender satisfaction clause? Would this constitute bad faith? Courts do not seem to believe so, as long as the lender can prove that said capital requirement is part of the bank's lending policy. Nevertheless, lenders must be extremely careful when establishing and, later on, accepting or rejecting the performance of these types of conditions.

D. Acceleration

Lenders frequently include in the loan agreement an acceleration clause[,] which will allow the lender, upon default by the borrower, to declare all future obligations immediately due and payable and, upon nonpayment, to foreclose on the loan collateral. The note or loan agreement generally will contain a list of various acts, or the occurrence of various events, that constitute an event of default, any one of which gives the lender the right to accelerate.³²

However, problems may arise if there is ambiguity in the documents regarding precisely what constitutes a default. In *First National Bank of Gainesville v. Appalachian Industries, Inc.*,³³ the court determined that any ambiguity in the meaning of a term in the loan document should be construed most strongly against the lender who was the author of the agreement. This doctrine prevails in our jurisdiction and is frequently raised, by borrowers, as a defense for not complying with, what they argue are, ambiguous provisions in the loan agreements. Thus, events of default should be clearly defined in these agreements in order to avoid confusion and ambiguity.

There is uncertainty as to whether a lender may exercise a right to accelerate a loan and demand payment of any outstanding balances without first allowing the borrower to cure the instances which gave rise to the default. Once again, the courts seem to be in disagreement as to how to answer this question. For instance, some cases state that a lender must first give notice of intent to accelerate and allow the borrower a reasonable time to correct the default upon which the acceleration is based. Once the final

³² *Id.* at 3-56 (citations omitted).

³³ *First National Bank of Gainesville v. Appalachian Industries, Inc.* 247 S.E.2d 422 (1978).

decision to accelerate has been made, further notice of the acceleration must be given to borrower to effectively cut off any remaining rights the borrower may have to cure the default.³⁴ On the contrary, other courts have enforced the express terms of a note, which stated that the bank, without notice or demand, could accelerate a loan upon a change in the financial condition of the borrower, which increased the bank's risks. The courts have also held that the fact that this acceleration provision could be exercised without notice did not constitute a violation of the implied obligation of good faith and fair dealing. What's more, other courts have held that all that is required is that the lender undertake some act, which signifies an intention to accelerate. This act may be an affirmative act, other than a demand or notice, or it can be a simple demand.³⁵

Local courts do not seem to have a problem with acceleration provisions. However, the local lender's practice is first to notify the default, allow for a curing period and then, if the default continues, accelerate the loan and demand payment. This is probably the safest practice for a lender when accelerating a loan, as it will demonstrate good faith and fair dealing to the court.

E. Bad Faith or Breach of Implied Covenant of Good Faith and Fair Dealing

An emerging theory of lender liability is breach of a covenant of good faith and fair dealing arising by implication from the loan commitment agreement. . . . To sustain a claim for breach of the good faith obligation, the party must first establish a breach of an express provision of a contract.³⁶

Most of the cases which have indicated that a lender may be liable for breaching the good faith requirement have involved an abrupt termination of credit, with insufficient or no advance notice, where there has not been a payment default. These have arisen in various contexts, including: "1) refusal to provide additional advances; 2) failure to renew a line of credit; 3) acceleration of loans; 4) foreclosure and repossession of collateral; 5) setoff and freezing of accounts; 6) refusal to accept late payments; and 7) refusal to continue honoring overdrafts."³⁷

³⁴ Anderson & Lettelleir, *supra* note 8, at 3-57 (citations omitted).

³⁵ *Id.* at 3-58 (citations omitted).

³⁶ *Id.* at 3-66 (citations omitted).

³⁷ Mannino, *supra* note 4 at 25 (citations omitted).

In Puerto Rico, the Supreme Court has stated time after time that the good faith principle permeates over contractual agreements.³⁸ In this respect, Art. 1210 of the Civil Code states that: "Contracts are perfected by mere consent, and from that time they are binding, not only with regard to the fulfillment of what has been expressly stipulated, but also with regard to all the consequences which, according to their character, are in accordance with good faith, use, and law."³⁹ Thus, it is evident that in our jurisdiction contracting parties are obligated to act in a good faith manner when enforcing obligations established in a loan agreement. Failure to do so would result in a possible award of damages to the affected party.

In jurisdictions similar to ours, where courts have recognized that a covenant of good faith and fair dealing exists in every contract, it has been determined, among other things, that "the purpose of this covenant is to preclude parties from engaging in conduct that will destroy or impede the right of the other party to receive the benefits of the contract."⁴⁰ These courts have held that "[t]he obligation to act in good faith cannot act to vary the rights and liabilities of the parties by a claim that in exercising a contractual right the party did not do so in good faith."⁴¹ "The good faith duty does not require that a bank refrain from enforcing the terms of the contract but only that a bank, in the exercise of its rights in enforcing contractual terms and obligations of the borrower, exercise good faith in its performance."⁴²

There is truly no standard factual instance in which the breach of good faith and fair dealing argument may be claimed by a borrower. Instead, it seems that borrowers will claim that lenders acted in bad faith under almost every circumstance in which they are alleging lender liability. Consequently, we may see arguments of breach of the good faith and fair dealing covenant in a variety of instances, although the court may not always sustain these arguments. Nevertheless, it is possible to think of several instances in construction financing in which a borrower may successfully contend that a lender acted in bad faith. For instance, when the lender refuses to disburse funds to cover certain line items in a construction certification without any reasonable justification. Or, furthermore, when a lender takes unreasonable time to handle a renewal of the line of credit or an increase in the amount of the loan, damaging the borrower's financial expectations in the process. What is reasonable or unreasonable is certainly a matter for the courts to decide, and will surely depend on the particular circumstances of each case.

³⁸ Velilla v. Pueblo Supermarkets, 111 D.P.R. 585 (1981).

³⁹ P.R. LAWS ANN. tit. 31, § 3375 (2007).

⁴⁰ Anderson & Lettelleir, *supra* note 8, at 3-68 (citations omitted).

⁴¹ *Id.*

⁴² *Id.* at 3-73 (citations omitted).

III. LENDER LIABILITY ARGUMENTS – NON-CONTRACT AND TORT THEORIES

Focus will now be turned to lender liability arguments arising from issues not contained in a loan contract agreement. These theories include, among others, the instrumentality theory or exercise of inordinate control, equitable subordination, fraud, duress, atypical lending practices, wrongful setoff, breach of fiduciary duty, and conflicts of interest. Of these doctrines, the instrumentality theory, or exercise of inordinate control, will be the most developed in this piece, since it is currently the most relevant to the construction industry, given the precarious financial position of many borrowers and the active involvement of lenders in trying to prevent further losses.

A. Instrumentality

Lenders, in a typical relationship, will exercise some control over a borrower, usually by including restrictive covenants in the loan agreement. As a means of controlling credit risk, it is also common for a lender to exact numerous conditions to their obligation to advance funds, and otherwise take various actions to periodically monitor the business of the borrower. In monitoring the business, the lender may take on somewhat of an advisory role and provide suggestions to the borrower as to the running of the business. Liability is dependent upon the degree of control that is exercised.⁴³

Under [the instrumentality doctrine], a lender becomes responsible for the debts of a corporation it controls where that control is so pervasive that the borrower becomes a “mere instrumentality” of the lender. Typically, three factors are required for lender liability: 1) the lender actually controls the borrower’s affairs; 2) the lender uses its control to commit fraud or to bring about an unjust result; 3) the lender proximately causes harm to the borrower through misuse of its control.⁴⁴

According to Edward F. Mannino, “while a lender may monitor a borrower’s business or participate in its affairs to protect its loan, it may not assume management control of the borrower and dominate its normal daily business affairs.”⁴⁵ “[C]ourts will permit a lender to monitor the affairs of its

⁴³ *Id.* at 3-77.

⁴⁴ Mannino, *supra* note 3 at 4 (citations omitted).

⁴⁵ *Id.*

borrower closely and give advice or suggestions to improve the business, so long as the debtor is not *required* to follow them.”⁴⁶

As economic conditions deteriorate, lenders will be forced to request borrowers in construction loans to, among other things, lower the prices of the units, slow down the pace of construction, as well as cut down on overhead, administrative and non-essential costs. The question under the instrumentality theory thus becomes, when do the lender’s actions exceed the standard practice, making him liable to the borrower under the instrumentality theory? More importantly, when does the lender become so intertwined with the borrower that he would be liable to third parties for actions brought about against the borrower?

The Supreme Court of Puerto Rico in *The Chase Manhattan Bank v. Emmanuelli Bauza*,⁴⁷ evaluated the question of when a lender becomes, so to say, the developer (borrower) in the face of third party claims. However, nothing is said about when a lender becomes liable to the borrower under the instrumentality doctrine. In the Chase Manhattan case the plaintiffs alleged that the Chase Manhattan Bank was jointly and severally liable, along with Chase’s borrowers, for the repair of a number of construction flaws found in houses of a development financed by Chase. The plaintiffs argued that since Chase disbursed funds for the repairs via one of the other defendants (Trust Mortgage), and prohibited Trust Mortgage from declaring dividends, issuing stock, selling their assets or dissolving the company, that they should be liable under the notion that Chase became the developer of the project as soon as they began exercising control over both the developer and Trust Mortgage. The Supreme Court rejected all of the plaintiffs arguments stating that under the material facts of the case, it could not be determined that Chase Manhattan Bank controlled any of the defendants or infringed the standard operating procedures of a financial institution. Thus, Chase could not be found liable for the construction flaws of the project.

Moreover, the court in the Chase Manhattan case reinforced the view, previously established in *United Federal Savings v. DACO*, of what constitutes a *developer* for purposes of third party claims, stating that:

Developer or Builder means any person engaged in the construction business as a trader, or primarily responsible, for the promotion, design, sales, construction of housing developments, or construction of housing on a large scale, either individual or multilevel. It includes the real estate broker, individual or business entity, who engages in the promotion or sale of individual or multilevel

⁴⁶ *Id.* at 7.

⁴⁷ *The Chase Manhattan Bank v. Emmanuelli Bauza*, 111 D.P.R. 708 (1981).

residential units; provided that the realtor is not responsible for the faulty construction of houses built and covered by this Chapter.⁴⁸

Based on this definition, the court concluded that the fact that Chase Manhattan had a pecuniary interest in the sale of the homes was not sufficient evidence to prove that they became a developer or exercised inordinate control over the actual homebuilder.

Both the *Chase Manhattan* and the *United Federal Savings* cases have become an integral part of the lenders' defenses against third party claims. In the past few years, claims have become extremely frequent, not only from third party contractors and suppliers, but also from individual purchasers and residents of construction projects, which are in the process of foreclosure. Many times, projects are left unattended while the project is being foreclosed, given that the borrower is no longer engaged in the development enterprise and the lender is not yet the title holder of the property. Thus, the projects are sometimes abandoned by both the developer and the bank, resulting in a lack of security, maintenance and care. This leads to a depreciation of property prices, being the bearers of the depreciation the individuals who decided to invest in the residential units developed.

These individuals will usually look to the Department of Consumer Affairs (DACO) to vindicate their rights against both the developers [borrowers] and the lenders. Even though many of these residents have no claim against the lender, given the lack of a contractual relationship, the experience is that DACO will pay little attention to arguments about lack of jurisdiction, and will hold a lender responsible for the deficiency in maintenance and security of a residential complex, as well as for construction defects in the individual units or in the project as a whole. Thus, lenders are forced to cite the *Chase Manhattan* and *United Federal Savings* cases in their attempts to avoid being liable for said claims. Most of the times, the lender is forced to appeal the DACO decision in the Court of Appeals in order to avoid liability. In the end, the decision for the lender becomes one of either paying to protect their collateral or paying lawyers to protect their pecuniary interests, whichever costs less.

A similar decision as in the *Chase* case is cited by Roy Ryden and Diane Lettelleir in a South Carolina appellate case which stated that the general rule is that "a construction lender is not responsible for torts committed by the borrower unless the lender exercises such control over the construction that would exceed the actions that are normally expected to be taken by a

⁴⁸ *United Federal Savings v. DACO*, 111 D.P.R. 424, 425 (1981), (translation provided by editor)

lender.”⁴⁹ Other examples provided by Edward F. Mannino as to when lenders have been found liable under the instrumentality theory are:

- 1) when the lender requires the borrower to turn over the proceeds from sales to the lender, with the lender paying bills from third parties;
- 2) when the lender precludes the borrower from encumbering assets, paying dividends, purchasing stock, or making capital improvements or repairs without the lender’s prior consent;
- 3) requiring the borrower consistently to sell its product to the lender at a loss and below market price;
- 4) requiring the borrower to implement strict and oppressive credit, sales and inventory policies for all of its products, and taking key personnel off salary.⁵⁰

All of these are circumstances, which may arise while dealing with troubled construction borrowers. Thus, lenders must make sure that their involvement in the borrower’s operations, decision-making, and day-to-day activities does not go beyond the customary practices for the industry. Furthermore, lenders must also be wary of their liability once they have foreclosed on a project and have become the title holders of the property. As a result of the lenders’ abundance [or perceived abundance] of financial resources, contractors and suppliers will demand payment for past services rendered and residents will definitely demand repairs and improvements to the foreclosed project, resulting in further losses, liability and costs for the lender. What we are beginning to see from lenders is an increase in the incorporation of Special Purpose Vehicles (SPV’s), which deal exclusively with the ownership and administration of foreclosed projects. This way, they intend to limit the liability of the financial institution to the assets available to that particular subsidiary or SPV.

B. Equitable Subordination

The equitable subordination doctrine is very closely related to the Instrumentality doctrine discussed above.

Under the doctrine of equitable subordination, bankruptcy courts sitting as courts of equity will subordinate the claim of a creditor which has engaged in inequitable conduct to the claims of other creditors. . . . Equitable subordination is a more flexible and stringent theory of liability than the instrumentality doctrine, and poses a far greater threat to lenders. It generally requires proof of three

⁴⁹ Anderson & Lettelleir, *supra* note 8, at 3-79 (citations omitted).

⁵⁰ Mannino, *supra* note 3, at 5 (citations omitted).

elements: 1) inequitable conduct, 2) injury to other creditors, or an unfair advantage to the wrongdoer, and 3) imposition of liability must not be inconsistent with the Bankruptcy Act.⁵¹ Most equitable subordination cases continue to turn on whether a creditor has engaged in inequitable conduct. Three broad categories of such conduct have been identified, consisting of (1) fraud, illegality, or breach of fiduciary duty, (2) substitution of debt for capital where the debtor is undercapitalized, or (3) use of the debtor as the creditor's alter-ego or instrumentality.⁵²

Most of the cases subordinating a lender's claim to those of other creditors have involved the exercise of extensive bank controls over every aspect of a debtor's day-to-day business. Mannino cites the case of *In re American Lumber Co.*,⁵³ in which a bank devised a liquidation plan, which barred other creditors from reaching the debtor's assets. As a result the bank opened all debtor's mail, collected all accounts receivable, terminated most of debtor's employees, hired security guards, drastically cut the salaries of the debtor's officers, determined which creditors to pay, and forced the debtor to execute security agreements in favor of the bank on its only free assets.⁵²

An example of one specific case of the doctrine of equitable subordination is whether a lender concerned with a borrower's substantial leverage and precarious financial condition may require the borrower to transfer the assets related to a particular construction project financed by the lender to a new entity- borrower which would only have the indebtedness linked to said project and payable only to that lender. Following an analysis of the doctrine discussed in this section, as well as of theories related to fraud, it would be safe to believe that bankruptcy courts would be very skeptical about this sort of transaction.

C. Fraud and Related Theories

Fraud is an ancient tort whose contours have been well settled over years of precedent and is now being applied in the lender liability context. . . . The elements of actionable fraud are: 1) making false representation concerning a material fact, or failing to disclose a material fact where there is a duty to do so; 2) making such statement or omission knowingly; 3) an intent by the maker of the representation to induce action or inaction by the recipient; 4)

⁵¹ *Id.* at 6 (citations omitted).

⁵² *Id.* at 7 (citations omitted).

⁵³ *In re American Lumber Co.*, 5 Bankr. 470 (D. Minn. 1980).

⁵² Mannino, *supra* note 4, at 7.

justifiable reliance by the recipient; 5) Damages proximately resulting to the recipient from the misrepresentation or omission.

Fraud has been found against lenders where they have made false threats to declare a default or call a loan, or false promises to provide or consider future financing or not call outstanding loans if additional security is given or management changes are made. Fraud has also been found where borrowers, in reliance upon false or incomplete representations by their lenders, have been induced to start a business prematurely, to invest in financially troubled enterprises controlled by or owing substantial sums to the lenders, or to accept the services of unwanted turn-around consultants.⁵³

Courts have also found that statements, which are literally true or ambiguous, may nevertheless be found to constitute fraudulent misrepresentations if they are misleading.

According to Mannino, several recent cases have also applied fraud, estoppel, breach of contract, unjust enrichment, equitable lien, and fiduciary duty theories to protect contractors or suppliers of a borrower from being deceived into continuing work or supplying the borrower, thereby adding value to the lender's collateral. For example, Mannino cites the case of *R.A. Peck, Inc. v. Liberty Federal Savings Bank*,⁵⁶ in which:

[A] lender was found to owe a duty to disclose to a contractor for the borrower that a construction loan account was depleted, where the lender had benefitted through the enhancement of the value of its mortgage collateral by the contractor's work, and had encouraged the contractor to submit its pay requests directly to the lender.⁵⁴

In this case the court stated:

The Bank's involvement in disbursing funds, transferring funds and making assurances regarding available funding in the future well exceeded a "normal lender's" role. Having chosen to thrust itself into the transaction, and placing itself in a position to reap financial benefits by its nondisclosure, it cannot now forego responsibility by cloaking itself under the duty of nondisclosure owed its customers.⁵⁵

⁵³ *Id.* at 15 (citations omitted).

⁵⁶ *R.A. Peck, Inc. v. Liberty Federal Savings Bank*, 766 P. 2d 928 (Ct. App. 1988)

⁵⁴ Mannino, *supra* note 3, at 17 (citations omitted).

⁵⁵ *R.A. Peck, Inc. v. Liberty Federal Savings Bank*, 766 P. 2d 928, 936.

Thus, it is evident from this decision, that banks may be held liable in cases in which they refrain from disclosing material information regarding their borrower's financial condition to third parties, if, under the circumstances of the case, they are benefitting from the third party's ignorance.

So far, we have seen how lender liability claims may arise from tort theories related to the lender's inordinate control of a borrower's operations or the lender's inequitable conduct as it pertains to the borrower's other creditors. Borrowers may have a claim under other tort theories such as duress, atypical lending practices, wrongful setoff, breach of fiduciary duty and conflicts of interest. These theories, although important, will not be discussed here due to the limited scope of this article and their minor relevance to construction financing. Focus will now be turned to the remedies available to borrowers who are successful in establishing their lender liability arguments.

IV. REMEDIES

"In general, damages in cases of breach of contract to loan money are the extra costs of obtaining funding elsewhere."⁵⁶

The traditional rule is that general damages for a breach of contract to lend money are to be calculated by the difference between the interest rate on the breached contract and the interest rate paid for a substitute loan. . . . [I]n most cases, then, the lender's liability will be limited to the relatively small additional amount that it would ordinarily cost to get a similar loan.⁵⁷

"In addition to general damages based on the interest differential (reduced to present value), the courts have also allowed the borrower to recover incidental damages for expenses incurred in procuring the substitute loan."⁵⁸ "If the borrower is unable to obtain substitute financing, the measure of damages is said to be the difference between the interest under the breached contract and the interest rate generally available to similar borrowers on the open market on the date of the breach."⁵⁹

⁵⁶ Anderson & Lettelleir, *supra* note 8, at 3-85.

⁵⁷ *Id.* (citations omitted).

⁵⁸ *Id.* at 3-86 (citations omitted).

⁵⁹ *Id.* at 3-87 (citations omitted).

[T]he developing modern rule is that the borrower may also recover consequential damages . . . also called *special* damages, subject to the general damage rules of foreseeability, avoidability, and certainty of proof. In the context of breach of loan commitments, consequential damages will usually take the form of the economic loss that the borrower has suffered on the underlying project which the loan funds were to be used to finance.⁶⁰

Examples of consequential damages, recognized by courts, include out-of-pocket expenses such as appraisal fees, commitment fees and broker's fees. Borrowers have also been allowed to recover expenses incurred in attempts to preserve the financed property, such as rent, taxes and interest. The most controversial form of consequential damages is lost profits on the underlying venture or property. However, new businesses, like a new construction development, present serious difficulties in proving anticipated profits with a reasonable degree of certainty. Thus, many courts have found the profits of such businesses to be too remote and speculative for recovery to be allowed.⁶¹

[A] potential borrower may also have a cause of action based upon promissory estoppel for damages incurred in reliance on promises made by the proposed lender during negotiations even though an enforceable commitment to lend is not consummated. In such cases, damages are usually measured to compensate for the reliance expenditures incurred; and loss of potential profits or other lost expectation damages are not allowed.⁶²

Finally, in cases in which the plaintiff pleads and proves that the contract breach also constituted a tort, punitive damages are recoverable. Under Puerto Rico's judicial system, punitive damages are not awarded to prevailing parties in tort cases. However, if the party is able to prove that the defendant's tortious conduct resulted in specific monetary damages, then courts will usually allow a plaintiff to recover the amount related to his or her losses. According to Ryden and Lettellier, in order for a court to award punitive damages:

a) there must be actual damages, meaning compensatory (as opposed to nominal) damages; and b) the lender must show actual malice, meaning 'conduct manifesting personal ill will or oppression,

⁶⁰ *Id.* at 3-89 (citations omitted).

⁶¹ *Id.* at 3-90, 3-91 (citations omitted).

⁶² *Id.* at 3-98 (citations omitted).

or showing a reckless or wanton disregard of one's rights'. Further, where the claim is against a corporation for actions of its employees, the acts must be those of the governing officers, or one lawfully exercising their authority, or the governing officers directed the act, participated in it, or ratified it.⁶³

V. CONCLUSION

As it has become evident throughout this article, lender liability is a complex body of law, which incorporates many contract and tort theories to protect borrowers from unjust treatment by their counterparties. Today, lenders face the same potential for liability that sellers of goods and services in the marketplace have faced for well over a century. As the economy in Puerto Rico and in the U.S. mainland continues its decline, many developers who see themselves defaulting on their construction loans will consider bringing about a lender liability claim against their lenders to escape the harsh effects of foreclosures and bankruptcy. Thus, we should expect many new developments in upcoming years regarding this body of law. We are already seeing some of these developments such as the Special Purpose Vehicles, the DACO cases, the third party claims against the lenders, and the more careful and creative drafting of loan documents taking place in the local jurisdiction. Hopefully, with what appears to be an imminent array of construction loan defaults and foreclosures, we will also see the jurisprudential vacuum existing in Puerto Rico, with regards to the lender liability doctrine, being filled.

⁶³ *Id.* at 3-95 (citations omitted).