LENDING AND RESTRUCTURING ALERT

OCTOBER 2002

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Corporate Fraud Brings Heightened Risk of Lender Liability

With reports of corporate fraud appearing more and more frequently, lenders to companies whose officers and directors have engaged in financial misconduct face an increased risk of a particular type of lender-liability litigation: Borrowers—the companies through whom the fraud was committed—may seek to recoup losses by accusing their lenders of aiding and abetting the breaches of fiduciary duties committed by their (probably former) officers and directors. Accordingly, to avoid potential pitfalls, it may be helpful to review the applicable rules.

The Rules

To be liable for aiding and abetting a breach of fiduciary duty under New York law, one must: (i) have had actual knowledge of the breach of duty; and (ii) have induced or participated in it.

Actual knowledge of the breach can be found even where the alleged aider and abetter did not intend to cause harm. But constructive knowledge—that is, if the lender had information that would cause a prudent person to make an investigation that would have uncovered the fraud—is not enough to impose liability for aiding and abetting the breach. Accordingly, allegations that the defendant acted with reckless disregard, or should have known, of the wrongdoing are insufficient.

To participate in a breach of fiduciary duty means to provide "substantial assistance" to the person breaching a fiduciary duty. This requires either affirmative assistance in committing the breach, helping to conceal the breach, or enabling the breach by failing to act when required to do so. It must be emphasized that inaction constitutes substantial assistance only if the alleged aider and abetter owes the victim a fiduciary duty.

Application

A New York bankruptcy court applied these rules when a large institutional lender sought to avoid liability in an action brought by one of its borrowers, a bankrupt company, that accused it of aiding and abetting a fraud perpetrated by the company's officers. The officers breached their fiduciary duties to the company in two ways: First, they caused the company to make misrepresentations to induce third parties to lend the company millions of dollars. Second, they also caused it to divert over $40 million of its funds to companies that provided no consideration in return. The company alleged that the bank knew of, and induced or participated in, the officers' looting of the company.

The bankrupt borrower also alleged that the bank, based on a similar experience with one of its other customers, suspected that a fraud was being committed, and after an investigation, concluded that the company had fraudulently created fictitious receivables. The bankruptcy judge ruled that, even if true, this allegation would, at most, support an assertion that the bank had actual knowledge that the borrower had inflated its

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receivables, not that its principals were looting it. While the bank might have suspected that the officers created false receivables to cover up their looting of the company, suspicion and surmise do not constitute actual knowledge. Notably, the court emphasized that the borrower/plaintiff had complained of two different breaches of fiduciary duties by the principals—the dissemination of false financial information and the looting of the company—but it had sought to recover only for the unlawful diversion of funds after the bank had allegedly discovered the fraud. Accordingly, the bank was not liable even though it discovered the falsity of the financial reports because it was not aware of the diversion of funds.

The court further ruled that the bank was not liable for participating in the fraud because it had neither induced it nor provided substantial assistance to those who breached their fiduciary duties. The relationship between a bank and a customer is not a fiduciary one, but only that of a debtor and creditor. Therefore, the bank owed no duty to the company to act and was not liable for "enabling" the fiduciary breaches.

The borrower also complained that the bank, after concluding that there was fraud, insisted that the company find replacement financing, and then dodged calls from potential new lenders who were unaware of the fraud. But the court found dodging telephone calls was nothing more than inaction, and the bank did not owe potential new lenders a fiduciary duty to disclose the conclusions it had reached about the borrower.

Conclusion

When a lender is confronted with fraud by a borrower and seeks to extricate itself from the credit, it should recognize the risk of potential liability for aiding and abetting the company's principals in breaching their fiduciary duties. It is important to be mindful of these rules that apply to not only dealings with those who may have committed the fraud, but also to contacts between the lender and third parties transacting with the borrower who seek information from the lender.

For more information on these issues, please call Paul Rubin **212-592-1448** or prubin@herrick.com, Andrew Gold **212-592-1459** or agold@herrick.com.

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