LENDERS LIABILITY

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ABSTRACT

In the context of the Indian banking system, lender's responsibility is a multifaceted legal phrase that defines banks' and financial institutions' responsibilities and obligations to their clients, particularly in the realm of lending practices. This phrase refers to a collection of legal concepts, regulatory standards, and case laws that have evolved over time to encourage ethical and equitable banking practices. Lender responsibility includes the duty of care, disclosure and openness, fair lending practices, grievance redressal systems, due diligence in assessing creditworthiness, adherence to prudential requirements, and regulatory monitoring. Both banks and borrowers must understand lender responsibility in order to maintain the integrity of the banking system and defend the rights and interests of all stakeholders. This abstract provides an overview of lender responsibility in the Indian banking sector, highlighting its significance as well as the regulatory framework that governs it.

Keywords: Lender, Bank, Liability, Borrower, Laws.

INTRODUCTION

Despite years of little action in the field of lender accountability, the exceptional collapse in the global economy and persistent uncertainty in the credit markets may prove to be fertile ground for disputes between lenders and borrowers, guarantors, or other third parties.[1]

Lending institutions saw a significant surge in claims in the 1980s and 1990s as they sought enforcement remedies in response to numerous defaults. More lenders are now pursuing enforcement actions, which may lead to more borrowers opposing lender practices and courts investigating such practices.

Lender liability is a branch of law that incorporates multiple theories of responsibility based on contract, tort, other common law, and legislation. The fact that these arguments are directed against lenders, particularly large financial institutions, is what brings them together.

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[1] Michael Mussa 'Factors Driving Global Economic Integration -- by Michael Mussa, Economic Counselor and Director of Research, IMF' [August 25 2000]

According to these ideas, causes of action might emerge when a lender's actions or inaction in connection with a loan result in losses to a borrower or a third party, either directly or indirectly.[2]

START OF LENDER LIABILITY

Lender liability cases rose to prominence in the mid-1980s, when a series of court decisions resulted in an increase in lenders being held liable for enforcing repayment terms under loan agreements. During this time, the courts significantly broadened the basis for holding lenders liable and routinely awarded high damages to plaintiffs. This tendency reversed in the late 1980s and early 1990s, with courts reducing some of the broader lender liability theories and even reversing high-profile verdicts from previous years. Despite this limitation, lender liability cases saw a renaissance beginning in the mid-1990s, owing in part to the spectacular rise of the second-lien market and an increase in the number of firms carrying debt loads inflated by cheap, easy money. Borrowers and impacted third parties are once again pursuing lawsuits against banks and other financial institutions in the current economic environment, not only to maximise their eventual recovery but also to increase leverage in workout negotiations.[3]

LEGAL THEORIES

Contract, tort, other common law, and legislation all serve as sources of lender liability theories.

Contract Theories

A lender-borrower relationship is a contractual link that allows a lender to be held liable for violations of written, oral, or implied contracts or agreements. A lender's failure to (a) lend after a loan commitment became legally binding, (b) extend a loan, honour loan modification terms, or refrain from exercising remedies after promising to do so, or (c) take actions required by loan documents or properly interpret loan documents is a common breach of contract claim.[4]

[2] Jeffrey Willis 'THE SUBSTANTIVE LAW OF LENDER LIABILITY', [1991] (Vol. 26, No.4) <https://www.jstor.org/stable/25762290> accessed 25 December 2023.

[3] Melissa Cassedy, 'The Doctrine of Lender Liability', [January 1988] (vol.40) https://scholarship.law.ufl.edu/cgi/viewcontent.cgi?article=2487&context=flr > accessed 25 December2023.

[4] E. Allan Farnsworth, 'Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations' Vol. 87, No. 2 (Mar., 1987), https://www.jstor.org/stable/1122561 , accessed 25 December2023.

Courts have considered a party's "course of conduct" as an important factor in interpreting contract provisions in breach of contract cases. In some situations, the parties' actions may even affect the stated requirements of a loan instrument, but only if they have consistently violated the stipulated restrictions. If this is shown, a lender's incapacity to perceive its own actions may result in an unintentional violation of the loan document's "amended" clauses. This does not, however, imply that a lender is obligated to comply with all requests made by counterparties to the loan agreement. Rather, a lender has the authority to expect strict adherence to the loan contract requirements but should keep in mind that a course of conduct is a fertile source of controversy about the true meanings of those words.[5]

Borrowers have also capitalised on the rising concept of breach of the implicit responsibility of good faith and fair treatment in typical breach of contract actions.

Despite the fact that good faith duty has certain characteristics with tort liability, courts are increasingly acknowledging it as a contract-based obligation.

Various countries' courts have accepted varying degrees of a covenant of good faith and fair conduct. In these jurisdictions, lenders have been found liable for (a) refusing to release a deed of trust in order to pressure the borrower into repaying another loan, and (b) manipulating the appraisement of the borrower's property to trigger a default and deliberately delaying foreclosure in order to increase the debt through interest accrual.[6]

K.M.C. Co., Inc. v. Irving Trust Co[7]. is one of the early cases in this field, with the 6th Circuit upholding a $7.5 million award against a lender. The lender was held liable for damages as a result of its arbitrary and unilateral refusal to advance funds to the borrower without prior notice. According to the court, the lender's refusal to provide notice violated the implied duty of good faith inherent in every contract. The court also stated that the lender's fair communication with the borrower may have impacted the result of the case. However, later cases have criticised the court's rationale.

[5] Shawn J. Bayern,' Offer and Acceptance in Modern Contract Law: A Needless Concept', Vol. 103, No. 1 (February 2015), https://www.jstor.org/stable/24758468 , accessed 25 December2023.

[6] Frances E. Freund, 'Lender Liability: A Survey of Common-Law Theories', v42(April 1989), <https://scholarship.law.vanderbilt.edu/cgi/viewcontent.cgi?article=2569&context=vlr > accessed 25 December 2023.

[7] K.m.c. Co., Inc., Plaintiff-appellant, v. Irving Trust Company, 757 F.2d 752 (6th Cir. 1985)

In addition to the "implied" covenant of good faith, the promise to act in good faith has statutory origins. The Uniform Commercial Code ("UCC"), for example, contains a provision stating that every contract entered into under the UCC is subject to a duty of good faith in its execution or enforcement. To put it another way, if the transaction is governed by the UCC, the parties must behave honestly. However, because of the uncertainty of the UCC's good faith requirement, the court's interpretation has been surprising.

Compensation for a lender's breach of contract is frequently limited to compensatory damages, which are generally defined as the additional costs of finding alternative financing. Because the covenant of good faith and fair dealing is primarily a contract condition that aims to carry out the parties' objectives, compensation for its breach has typically been limited to compensatory damages alone. Furthermore, while most courts may now consider awarding consequential damages in the context of a loan transaction, punitive damages are frequently not recoverable.

Tort Theories

Although lenders can be sued for a variety of torts, this article will focus on the ones most commonly alleged by borrowers: fraud, economic coercion, tortious interference with a contract, and negligence.

A fraud lawsuit may arise when a lender makes a significant, fraudulent misrepresentation with awareness of its dishonesty or conceals a key truth when it has a duty to disclose, resulting in damages to a borrower or third party in either case. Despite the fact that the law does not force a lender to answer an inquiry in the first place, the lender's voluntary response may impose an obligation to provide further, relevant information in a true and complete manner. Affirmative representation is frequently employed in fraud. Even if a lender has no true fraudulent intent, constructive fraud may arise if the borrower and lender establish a trusting relationship and the lender then violates its obligation to the borrower.

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A claim for economic duress may arise when a lender threatens a borrower with acts over which the lender has no legal authority or demands more than the borrower is legally required to grant, in either case at a time when the borrower has little choice but to comply with the lender's demands. The courts have differentiated between a lender (a) making unlawful threats or demands and (b) threatening to do or refuse to do what it has a legal right to do. Because evaluating whether a lender utilised legitimate rights or remedies unlawfully is difficult, courts have preferred to hold lenders liable in situations where the lender's action was tainted by fraud or misconduct.[8]

When a plaintiff has a valid contract with a third party, the lender is aware of the contract and intentionally induces the third party to breach the contract, or the lender prevents the plaintiff from performing on the contract, and the plaintiff suffers loss as a result of such interference, tortious interference with a contract claim may arise. This privilege, however, has been extended to lenders who have interfered with contracts in good faith by pursuing their rights and remedies. Different methodologies have been used by the courts to determine whether malice or deliberate or improper motivation are needed components of this cause of action. In addition, some courts have allowed lenders to interfere in contracts between borrowers and third parties provided the lenders have equal or superior interests in the subject matter. Lost profits and other reasonably anticipated losses may be recovered if an interference claim is successful.[9]

Under the concept of negligence, lenders may also be held liable to borrowers and third parties. To successfully file a negligence claim, a plaintiff must normally show that the lender owed the plaintiff a duty of care, that the lender breached that duty, and that the breach proximately caused the plaintiff's injury. The underlying rule is that a lender has no duty of care to a borrower if the lender's involvement in the transaction is limited to its conventional role as a mere lender of money.

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Other Common Law Theories

When the lender-borrower relationship departs from the traditional creditor-debtor relationship, the lender may be held liable.

The instrumentality hypothesis states that a lender may be directly obligated to the borrower and other parties if it exercises sufficient influence over the borrower's day-to-day operations that the lender essentially becomes the borrower. However, from this vantage point, just giving funds and monitoring a borrower's business transactions does not impose direct accountability.

[8] Douglas R. Richmond, 'FRAUD AND MISREPRESENTATION CLAIMS AGAINST LAWYERS' [2016] (16:57) < https://scholars.law.unlv.edu/cgi/viewcontent.cgi?article=1652&context=nlj > accessed 25 December 2023.

[9] Lee Hishammuddin Allen & Gledhill, 'Tortious Interference with Contract' (Lexology 2021) <https://www.lexology.com/library/detail.aspx?g=54070b40-2175-40c6-83a4-e4ed1cfbe655 > accessed 25 December 2023.

Liability is imposed instead if the lender's involvement in the administration and management of the borrower's firm is sufficient to demonstrate the creditor's genuine, participating, and complete control over the debtor. Direct liability may also exist where, contrary to the instrumentality theory, the lender exercises significant control over the borrower, such that the lender is characterised as the borrower's agent or principal, or the lender's relationship with the borrower is more akin to a partnership or joint venture.[10]

Furthermore, when a lender's excessive control or dominance over the borrower's business activities transforms an ordinary creditor-debtor relationship into a "special" one, a fiduciary relationship may arise between the lender and the borrower. The following elements must be present in order to establish a fiduciary relationship between a bank and a debtor, according to one recent decision: (a) the borrower has faith, confidence, and trust in the bank; (b) the borrower is in a position of inequality, dependence, weakness, or lack of knowledge; and (c) the bank exercises dominion, control, or influence over the borrower's affairs. When a fiduciary duty is established, the lender owes the borrower many more obligations than those derived from a loan agreement.

Courts have previously rejected efforts to increase lender liability in order to impose regulatory and reporting responsibilities on lenders when borrowers engage in actionable misbehaviour. The 2nd and 7th Circuits held that where no fiduciary duties exist, lending institutions have no legal obligation to warn third parties of the borrower's fraudulent acts when addressing whether lenders should be held liable for aiding and abetting improper actions and poor business decisions taken by management of failing businesses.

Statutory Theories

State and federal statutes may also be invoked in lender liability claims.

As previously established, all transactions subject to the UCC are subject to a duty of good faith. Thus, if a contract is covered by the UCC, a borrower may seek compensatory damages

[10] K. Thor Lundgren, 'Liability of a Creditor in a Control Relationship with its Debtor'[1984] (Vol. 67 ,Iss. 3) <https://scholarship.law.marquette.edu/cgi/viewcontent.cgi?referer=&httpsredir=1&article=1931&context=mulr> accessed 26 December 2023.

for a lender's breach of good faith without first establishing the existence of a fiduciary relationship.[11]

Under the Internal Revenue Code ("IRC"), a lender who has enough control over a borrower may be accountable for withholding federal taxes. In addition to accountability for the actual taxes (plus cumulative interest) owed, the IRC authorises the collection of statutory penalties for willful withholding of federal taxes.

Courts have also held lenders liable under the Racketeer Influenced and Corrupt Organisations Act ("RICO") for engaging in prohibited RICO activities. RICO, in addition to criminal penalties, offers a private right of action for civil damages, allowing persons or businesses impacted by a RICO violation to seek treble damages.

Furthermore, considerable lender litigation has occurred under the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") in relation to lenders exercising some degree of control over the day-to-day functioning elements of a borrower's mortgaged property. If a lender is determined to be an "owner" or "operator" under CERCLA, it may incur civil fines as well as the costs of cleaning up contaminated property.[12]

LENDER'S LIABILITY IN THE INDIAN BANKING SYSTEM

Prudent lending practises and duty of care:

Case Law: A fundamental component of lender liability is the duty of care owed by banks to their customers. The Supreme Court of India ruled in **Standard Chartered Bank v. Andhra Bank** [13]that banks have a duty to ensure that they do not act negligently and that their operations do not harm their clients. This case illustrated the need for banks to conduct thorough due diligence before extending loans to customers.

[11] Jeffrey Willis, 'THE SUBSTANTIVE LAW OF LENDER LIABILITY' [1991] (Vol. 26, No. 4) <https://www.jstor.org/stable/25762290> accessed 26 December 2023.

[12] Brynne Peluso and another, 'RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS'[2023](Vol. 60, Issue 3)<https://go.gale.com/ps/i.do?id=GALE%7CA751898043&sid=googleScholar&v=2.1&it=r&linkaccess=abs&issn=01640364&p=AONE&sw=w&userGroupName=anon%7E8fd1ff1f&aty=open-web-entry> accessed 26 December 2023.

[13] *Standard Chartered Bank v. Andhra Bank Financial Services Ltd.* [2006] INSC 554, (2006) 4 SCC 724.

Transparency and disclosure:

The National Consumer Disputes Redressal Commission (NCDRC) determined in **ICICI Bank v. Hemant Govind Kadam** that banks must provide borrowers with clear and full information on loan terms and conditions, including interest rates and taxes. Failure to do so may result in a breach of the lender's duty.

Loan Recovery and Fair Practises:

Case Law on Harassment and Torture by Bank Recovery Agents: The case of Harassment and Torture by Bank Recovery Agents highlighted the need for banks to adhere to fair practices and ethical standards when recovering loans. The Court found that the bank might face legal consequences if recovery workers employed harsh and coercive measures.[14]

Mechanisms for Resolving Complaints:

Case Law: The Supreme Court underlined the need for banks to have sufficient grievance redressal processes in place to resolve client issues in **Union Bank of India v. Somireddi Muthyalu**. This example illustrated the importance of providing consumers with a fair and accessible way to resolve complaints.

Due Diligence and Credibility:

Case Law: In the case of **United Bank of India v. Uday Narain Pandey**, the Supreme Court said that banks must do extensive due diligence in order to establish the creditworthiness of borrowers. Failure to do so may subject banks to liability for lending to untrustworthy borrowers.

Prudential Regulation and Oversight:

Case Law: The RBI has produced asset classification and provisioning guidelines within the scope of prudential standards. Banks must follow these guidelines in order to maintain the financial system stable and secure. The case of **RBI v. Jayantilal N. Mistry** emphasises the

[14] REKHA KRISHNAN and RAJIV KRISHNAN KOZHIKODE, 'Status and corporate illegality: Illegal loan recovery practices of commercial banks of India' [2015] (Vol. 58, No. 5, pp. 1287-1312) < https://www.jstor.org/stable/24758222 > accessed 26 December 2023.

need for banks to adhere to the RBI's prudential rules, and failure to do so can result in regulatory action.[15]

CONCLUSION

Lender accountability is a difficult and evolving legal concept within the Indian banking system aimed at maintaining a fair and balanced relationship between financial institutions and their clients. It encompasses a wide range of legal ideas, regulatory norms, and case laws, all of which are vital for sustaining the banking industry's integrity and defending the interests of both borrowers and lenders.

Lender liability law has been extensively influenced by economic and financial market changes since its inception. Lender liability law grew in the 1980s to cover a number of legal theories based on contract, tort, other common law, and legislative authorities. The term "course of conduct" has frequently been used in breach of contract proceedings to interpret the terms of a loan contract. The implied covenant of good faith and fair conduct has been widely understood and accepted in loan agreements, but its application has been severely constrained. The most common tort liability grounds include fraud, economic duress, tortious interference with a contract, and negligence.

Finally, lender liability is a dynamic and critical aspect of the Indian banking system. It is critical in promoting justice, openness, and client protection while also ensuring the financial sector's stability. Borrowers and lenders should be aware of their rights and responsibilities under the lender's responsibility framework, which establishes the legal landscape of banking in India and contributes to a robust and responsible financial system. As the financial industry advances, lender accountability is a cornerstone in establishing responsible and ethical banking practices in India.

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[15] *RBI v. Jayantilal N. Mistry* [2015] AIR 1 SC 2016