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War Story: Bank Shakedown?

By Greg Veal June 14, 2018

Have you ever battled a lender over priority to contract funds? [Sure you have.] And have you ever taken collateral or collected indemnity without knowing the source of the funds? [Same answer.] But have you ever been sued by a bank for taking collateral or collecting indemnity?

When faced with demands for collateral and indemnity, indemnitors may voluntarily grant the surety a security interest in properties previously conveyed to family or controlled entities without consideration. Indemnitors may even post cash collateral or make payments against their liability under the GAI. A disappointed lender, learning of those transactions, could then sue the surety—it has happened.

In summary, a bank alleged that the surety knew its indemnitors had only very limited resources, all of which were encumbered, knew they were planning to sell liened equipment to raise money, and knew the bank's UCC filings covered that equipment. When the surety received cash collateral, the bank sued and argued the surety must have known the funds came from an equipment sale that violated the bank's UCC rights. The lender alleged the surety was not a good-faith holder, demanded the proceeds received be disgorged, and further claimed against the surety for *all* of the sales proceeds—even amounts the surety had not received—based on conspiracy. The bank also demanded punitive damages for fraud and conversion.

As for the real property, the surety had sued to set aside the fraudulent transfers but then settled in return for a security interest in the properties rather than enforcing reconveyance for the benefit of all creditors. The bank again sued the surety, this time for allegedly conspiring in the indemnitors' fraud by taking the security interests and, ultimately, the proceeds of sale.

Because the surety had some knowledge of the bank's rights, had communicated with the indemnitors about their plans for raising funds, and could not conclusively *disprove* a conspiracy to evade the bank's interests, the surety could not prevail against the bank's claims by moving to dismiss. The bank had no evidence of any collusion or participation by the surety in the indemnitors' misconduct, because there was none, but excluding the possibility at the outset was impossible. A nuisance-value settlement offer was ignored. The surety thus was forced to remove and defend two lawsuits, proceeding well into discovery.

The bank forced the surety to incur substantial legal expense before realizing it had no case. Out of the blue, over two years after first raising its claims, the bank spontaneously dismissed both of its lawsuits. Without so much as a *de minimis* demand or even suggesting a compromise, the lender folded its tents.

Did the bank ever believe in its case? Was it merely trying to extort a recovery from the surety when all of its remedies against its borrowers and guarantors failed? Was this a bank shakedown?

Instead of a malicious shakedown attempt, this all likely resulted from the bank's determination that it had to pursue the lawsuits to satisfy its duty to the Small Business Administration. See 13 C.F.R. 120.410 (lender must demonstrate the ability to service, liquidate, and "litigate" the loan). The principal's loans were guaranteed by an SBA program that requires the lender reasonably to pursue recovery, including litigation, unless the prospects don't justify further pursuit.

The surety knew that, after discovery, it would be able to show that it did nothing wrong. The surety did not know the source of the indemnitors' collateral posting. It did not encourage or help the indemnitors sell equipment encumbered by the bank's lien. The surety could not have known whether the indemnitors had other resources from which to raise the funds. So in fact and law the surety was a good-faith holder of the collateral. The real property had not been subject to any of the bank's rights, so the surety knew it was not prohibited from negotiating to receive the first-priority interest in those properties and the proceeds of the later liquidations.

The surety's defense called the claims into serious question and allowed the bank to show SBA that the cost-benefit ratio was upside down, so the bank could abandon its efforts and still call on the SBA guaranty. The surety did what it had to do in response to the bank's claims: offered initial defense-cost value to settle (but with no counteroffer), defended to the minimum extent required, but ultimately pushed back hard enough to deter further action by the bank. If only the bank had accepted the surety's defenses up front, both sides could have saved very substantial expense.

Sureties that take collateral cannot prevent lenders from mining for bad facts when frustrated at being left out of indemnitors' asset distributions. Lenders with SBA guaranties may believe themselves duty-bound to try. Be aware of those dynamics, and be prepared to defend recoveries against such ill-advised attempts.