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Lender Liability: The Legal and Management Effects on the Hospitality Industry

Abstract
With the savings and loan crisis and the tail end of a recession at hand, the '90s are bound to be a difficult decade for the financing of hospitality operations through borrowing from commercial lenders. The authors discuss one of the least known dangers associated with borrowing, lender liability. The issue is discussed from both a legal and managerial perspective.

Keywords
John L. Myers, Bruce S. Urdang, Lender Liability: Legal and Management Effects on the Hospitality Industry, Borrowers, Partnerships, Participatory loan, Agency

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Lender Liability: Legal and Management Effects on the Hospiality Industry

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With the savings and loan crisis and the tail end of a recession at hand, the '90s are bound to be a difficult decade for the financing of hospitality operations through borrowing from commercial lenders. The authors discuss one of the least known dangers associated with borrowing, lender liability. The issue is discussed from both a legal and managerial perspective.

Individuals involved in upper level management who have been properly advised by counsel are becoming increasingly aware of the legal issues surrounding that relatively new area of the law commonly referred to as "lender liability." The rights and liabilities between a borrower (the hospitality management) and a lender (traditionally a commercial bank, savings and loan, retirement/pension fund, and insurance company) have changed significantly over recent years.

Under certain circumstances, a lender could be held legally responsible to third parties for the wrongful acts or omissions of the borrower.[1] The possibility of such liability has had a profound effect not only on the nature of the borrower/lender relationship and the structure of loan agreements, but also on the decisions rendered by the management of hospitality operations. Management has had to recognize the fact that lenders are increasingly wary of becoming entangled in the myriad legal problems which beset all hospitality operations. The effect has been a significant change in management procedures and attitudes.

Often the law will hold one person vicariously liable to a third party for the acts of another merely due to the relationship between the parties. One example is the liability placed upon an employer for the acts of his employee. Just because of the relationship, one person is responsible for the acts of another as if those acts were his own. Such vicarious liability could attach to a lender with regard to the acts of a borrower. For such liability to attach, the relationship between lender and borrower must, in many ways, be more than what one might consider the traditional lender/borrower relationship.

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Traditionally, a lender will charge interest as the consideration it is to receive for a loan. The only obligation placed upon the borrower is to re-pay the principal with the agreed-upon interest. The only right the lender has is to receive the sums owed. Increasingly, however, lenders have sought to increase the profitability of lending by making "participatory" loans. Lenders receive an ownership interest in the borrower's business, often a percentage of the profits. To protect that ownership interest, many such loans include the delegation of management responsibilities to the lender. It is such "participatory" loans which could result in lender liability.

Are the Lender and Borrower Partners?

According to the Uniform Partnership Act, all the members of a partnership are liable for the acts of the other partners which are related to the partnership business. A lender who has made a participatory loan to a borrower might be so entangled in the daily operations of the borrower that the lender appears to be a partner and therefore liable for the "partnership" debts.

A partnership is defined as an association of two or more persons to carry on a business for profit as co-owners. The hallmarks of such an association are as follows:

- **Intent to form a partnership:** No person can be a partner with another without intending to do such. In this context, however, intent can be inferred by the parties' acts. The parties might even deny that they are partners; however, if they act like partners, the law will consider them such.

- **Community of interest:** This means having the right to manage the affairs of the business or utilize or dispose of business property. The key is the right to manage. Exercising that right is not necessary. Contrast such management authority with a lender's right to veto certain transactions of the borrower which in some way might endanger the lender's collateral. Such an arrangement would not be considered a community of interest and would be a "safe" right for a lender to reserve.

- **Co-ownership:** The most powerful indicator of co-ownership of a business is the sharing of profits. Often lenders will receive a share of the profits of a business as payment on the debt or interest on a loan. Not all such loan terms will make a lender a partner of the borrower, even though such a lender might look like a partner. The key, therefore, is the ability to distinguish loans from capital investment.

- **Power of control:** A creditor who takes over a debtor's business to collect on a debt or who is involved in the debtor's day-to-day affairs, might be considered the debtor's partner. A lender may appropriately monitor or protect its interest in collateral without running the risk of being branded a partner.

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In attempting to make such an often difficult distinction, the single most significant factor will be whether or not the obligation to re-pay the funds is contingent upon the success of the business.[2] Partners, in addition to sharing profits, share losses. If the obligation to re-pay is absolute, regardless of the success of the business, no co-ownership exists, even if the amount of the payments were to vary with the profits of the business. Such is the rule in nearly every state. No inference of partnership is created by the repayment of lent money out of the first proceeds of a business or out of its profits. It is where the money advanced is risked in the business that the courts will hold that co-ownership exists:

> To constitute a loan the money advanced must be returnable in any event.... It is not a loan if repayment is contingent upon the profits, for in such a case it is made not upon the personal responsibility of the borrower, but upon the security of the business; and where the money is risked in the business,it strongly tends to show that the contract was one of partnership, and not a mere loan.[3]

In many cases, lenders go further. Instead of extracting only interest as remuneration for a loan, they also receive profits. Such additional interest, in the form of profits, in and of itself does not transform a loan into a capital investment.[4]

One final situation involves a lender who, according to the loan instrument, is to continue to receive a percentage of profits of the borrower even after the entire principal and interest have been repaid. There is no case directly holding that such an arrangement will be tantamount to a community of interest. However, one court has held that one of the primary characteristics of a loan is the existence of principal sums outstanding.[5] The corollary to that proposition is that no lender/borrower relationship can exist if there is no outstanding principal owed and, therefore, if the relationship is not one of lender/borrower, it must be something else, such as a partnership.

One can only speculate as to how such an argument might be received. The best advice would be to not become the test case and to avoid loans which permit the payment of profits after the principal has been repaid. Some loan transactions attempt to accomplish the same result by providing the lender not with a payment of profit after the principal is paid, but granting the lender an option to become a partner in the borrower's business at some specified time in the future. The time specified might be after the principal has been paid. Because the lender will exercise that option only if the business is, in fact, profitable, the option is in effect an agreement whereby the lender is agreeing to share in profits if they ensue, but not to share in any losses. Such an option arrangement has been held not to constitute a partnership.[6]

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Is the Borrower the Lender's Agent?

Another ground upon which vicarious liability for the acts of a borrower could be thrust upon a lender is that of basic principles of agency law. A principal is vicariously liable for the acts of his agent conducted within the scope of the principal's business. To put this proposition of law into the context of the lender-borrower relationship, Section "O" of the Restatement (Second) of Agency states the following:

> A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business.

An agency relationship can be created in two ways. The first is by consent, one person agreeing to act on behalf of another. The other is as stated above, by a lender exercising control over the business of the borrower for the mutual benefit of both. Notice that for such agency liability to attach, actual exercise of control, not merely the right to control must exist, unlike the partnership analysis above. The Restatement of Agency goes on to state the following:

> The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

It is important to note that a lender who acts merely to protect its collateral through a veto power over transactions such as mergers and acquisitions or the sale of substantially all of the borrower's assets will not be considered the borrower's principal. Likewise, a lender with veto power over transactions which are above a certain dollar amount or who has the power to enforce rights of the borrower against a third party will not have vicarious liability for the acts of the borrower thrust upon it.

Securities Liability Differs

Both federal and most states' securities laws state that a person who is in control of an issuer of securities will be vicariously liable for such issuer's violation of the securities statutes. The meaning of the term "control" for securities law purposes is not the same as set forth in the partnership or agency analysis. In fact, the courts are somewhat split as to the standard to be applied for the imposition of liability. Some courts have held that for such liability to attach to a lender, the lender must have more than the mere right to control the transaction in question. Some evidence of actual participation in the securities law

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violation is needed. Such is referred to as the "culpable participation" requirement.[7] The requirement that the lender have actual knowledge of the conduct and actively participate in the violation offers some fairly strong protection to lenders. That can be contrasted with a recent federal court opinion[8] wherein it was stated that the right to control the transaction in question even without proof that such control was actually exercised could be enough to hold a lender vicariously liable for a borrower's securities law violation. Therefore, lenders which might be aware that an insolvent borrower is considering selling securities to raise capital should insist that the legality of any security offering be certified by independent counsel.

Management has had to recognize the fact that lenders are increasingly wary of becoming entangled in the myriad legal problems which beset all hospitality operations. The effect has been a significant change in management procedures and attitudes for both borrower and lender.

One such effect has been management's recognition of the dangers which accompany any delegation of management responsibility to a lender. Most lenders require some degree of control over the operations of the borrower if it is to make a participatory loan. Such loss of control over its own operation may not be desirable to management, especially if the lender to whom decision making authority is being delegated is not knowledgeable about the nature or operations of the borrower's business. A hospitality operator does not know how to manage the operations of a lending institution; why, then, should lenders be expected to know how to manage a hospitality operation? Clearly, a hospitality operator should be circumspect about delegating decision making authority to persons with little or no hospitality industry experience.

Managers Must Explore Options

Before entering into any participatory loan agreement with a lender, management must explore other, more traditional lending arrangements. Perhaps the obligation to re-pay the loan should be absolute and not contingent in any way on the success of the business. This would effectively exclude the lender from participating in the business operations. However, lenders might find themselves unwilling to lend if the rewards it is to receive are not great enough, and, therefore, they might insist on a share of profits. Management's need for funds may be the determining factor when trade-offs with a lender are required. Ownership, profits, and control are surely the heart and soul of business ownership. Involving and permitting others to participate in this process must be evaluated carefully based on the willingness of lenders to make non-participatory loans and the borrower's need for financial support.

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The risks which lender liability places upon a lender involved in a participatory loan with a hospitality operation are enormous. Should a borrower be determined by a court to be liable to a third party for breach of contract or for some violation of the law, not only does the lender risk the possible insolvency of the borrower and its inability to re-pay the loan, but the lender itself may have to step into the shoes of the borrower and make good on its obligation.

A lender contemplating making such a loan must consider such potential liability. Perhaps such risks do not justify the return that such a loan would generate. If, after considering such risks, the lender concludes that such a loan would make economic sense, then the lender must obtain legal advice so the responsibilities, duties, and respective authority of the partners can be clearly spelled out. The lender must be certain to obtain enough control in order to protect its interest in the business. It must then devote sufficient resources to properly and effectively exercise such control.

The lender must also recognize its own infirmities with regard to its ability to manage the borrower's business. Just as a borrower should be circumspect about tendering control of its business to a lender which knows little about managing a hospitality operation, a lender must recognize that just because it is knowledgeable about the business of providing financial services, it may be quite ignorant about how to manage an ongoing business. If so, a wise lender would not enter into a participatory loan.

The common thread running through all of the grounds upon which a lender might be held liable for the act of a borrower is control. A wise lender who recognizes the risks involved with participatory lending will refrain from exercising control over the day-to-day operations of the borrower unless it has made a conscious decision that it wants the rewards associated with such a high risk loan and it dedicates the resources needed to properly and effectively participate in the borrower's business. A lender who does not wish to risk lender liability will be certain that the obligation of the borrower to re-pay the loan is absolute, regardless of the success of the business, even if the lender is to receive a share of the profits as part of the consideration for making the loan.

Owners and managers of hospitality operations, on the other hand, should be cautious as to their positions with lenders. The relationship could be one of bliss or one of courting disaster. The pros and cons of participatory loans, legal entanglements, risk venture, and overall control must be viewed with skepticism as well as opportunity. The uninformed borrower or lender is sure to suffer.

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Legal Citations

[1]Connor v. Great Western Savings & Loan Association, 69 Cal. 2d 850, 447 P.2d 609 (1968).

[2]In re Washington Communications Group, Inc. v. Henry, 18 B.R. 437 (D.D.C. 1982); P&M Cattle Co. v. Holler, 559 P.2d 1019 (Wyo. 1977).

[3]May v. Sexton, 68 Ariz. 358, 206 P.2d 573 (1949) at 575.

[4]Carefree Carolina Communities, Inc. v. Cilley, 29 N.C. App. 724, 340 S.E. 2d 529 (1986).

[5]Kline v. Robinson, 83 Nev. 244, 428 P.2d 190 (1967).

[6]Martin v. Peyton, 246 N.Y. 213, 158 N.E. 77 (1927).

[7]Orloff v. Allman, 819 F.2d 904 (9th Cir. 1987).

[8]Metge v. Baehler, 762 F.2d 621 (8th Cir. 1985), cert. denied, 474 U.S. 1057 (1986).

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