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### Lender Liability

*Courts Restrict Aiding and Abetting Claims*

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**B**anks and other lenders that extend credit to borrower corporations may be held responsible when those borrower corporations defraud or wrongfully default on obligations to third party investors. However, investors attempting to recover from these borrowers' banks for aiding and abetting a borrower's fraud face an uphill battle. As recent decisions in New York and around the country make clear, banks and other lenders have almost no duty to inform or warn their borrowers' investors, even when the banks suspect that their borrowers are unscrupulous. Absent actual knowledge of a borrower's fraud coupled with active participation in that fraud, a bank will not be held accountable to third party investors.

#### Aiding and Abetting Fraud

When corporations defraud or default on their obligations to investors, those investors may attempt to recover their damages from the corporations' lenders on the grounds of aiding and abetting the fraud which precipitated the default. In New York, a claim for aiding and abetting fraud requires a showing of (1) an underlying fraud, (2) the defendant's actual knowledge of the fraud, and (3) the defendant's substantial assistance in the fraud. Mere constructive knowledge, or inaction in the face of actual knowledge, is not enough to impose liability.<sup>1</sup> "Substantial assistance" exists only where (1) the defendant

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"affirmatively assists, helps conceal," or, by failing to act when it has a duty to do so, enables the fraud to occur; and (2) the defendant's actions proximately cause the harm on which the primary fraud is based.<sup>2</sup>

A recent example is *Jebran v. LaSalle Bus. Credit LLC*, No. 61057/2005 (N.Y. Sup. Ct. Jan. 17, 2006) (Freedman, J.), where the court dismissed an investor's aiding and abetting fraud claim for failure to state a cause of action. Defendant LaSalle Business Credit LLC had established a \$20 million credit facility for borrower Invatech Corporation. When Invatech was unable to meet its obligations to LaSalle, LaSalle agreed to waive Invatech's defaults. In an attempt to raise funds, Invatech offered subordinated loan agreements to potential investors in which Invatech warranted that it was not in default on any of its obligations. Plaintiff-investors entered subordinated loan agreements with Invatech, investing \$900,000. When Invatech later defaulted on its agreements and filed for bankruptcy, plaintiffs sued LaSalle, claiming that Invatech's representation that it was not in default was misleading given that Invatech would not have been in default absent LaSalle's waiver. Plaintiffs also claimed that LaSalle had aided and abetted Invatech's fraud by failing to warn the subordinated loan

investors about Invatech's financial condition. According to plaintiffs, LaSalle withheld this information in order to induce investors to infuse Invatech with assets that could be used to repay LaSalle.<sup>3</sup>

The court dismissed plaintiffs' aiding and abetting claim, holding that there was no showing of either an underlying fraud by Invatech or substantial assistance by LaSalle. There was no underlying fraud because Invatech's statement that it was "not in default" was in fact true; that Invatech was free from default only as a result of LaSalle's waiver did not make the statement fraudulent. Further, these "sophisticated" investors could not claim that they had reasonably relied on any misleading statement because they had warranted in the loan agreements that they were aware of the risks of investing in private early stage companies and that they had access to all necessary information.<sup>4</sup> The investors also failed to show that LaSalle had "substantially assisted" Invatech merely by its silence and inaction. Even if it could be shown that LaSalle knew that Invatech would be unable to meet its obligations to the investors under the subordinated loan agreements, LaSalle had no duty to disclose that information to the plaintiffs.<sup>5</sup>

#### Near Immunity

This no-duty-to-disclose rule has been applied to grant near immunity to lender banks, even where the borrower's misconduct is extensive and even where the bank is all but certain that the borrower is engaging in fraud. In *Albion Alliance Mezzanine Fund, LP v. State St. Bank & Trust Co.*, 8 Misc.3d 264, 797 N.Y.S.2d 699 (Sup. Ct.) (Cahn, J.), aff'd 2 A.D.3d 162, 767 N.Y.S.2d 619 (App. Div. 1st Dep't 2003), the court dismissed an aiding and abetting fraud claim that arose out of a

“massive fraud” by the defendant-bank’s borrower. Between 1997 and 1999, Sharp International Corporation fraudulently diverted over \$44 million through improper cash disbursements and overstatements of sales and purchases.<sup>6</sup> State Street Bank, which had extended \$23 million in credit to Sharp, began to suspect Sharp of improper activity because of its inadequate financial reporting and its dealings with a company that had recently perpetrated a massive fraud. State Street placed Sharp under increased scrutiny and launched an investigation of Sharp and its principals, eventually learning that many of Sharp’s purported customers were in lines of business unrelated to Sharp, were no longer in business, or were fictitious.<sup>7</sup>

In order to ensure repayment of Sharp’s loan, State Street encouraged Sharp to seek financing from other investors. Plaintiff-investors reviewed Sharp’s audited financial statements and were advised that their investment would be used to repay Sharp’s State Street loan. Although plaintiffs contacted State Street for information, State Street allegedly declined to take their phone calls. Nonetheless, with State Street’s consent, plaintiffs invested \$25 million in Sharp. When Sharp failed to meet its obligations to plaintiffs, plaintiffs sued State Street for, among other claims, aiding and abetting Sharp’s fraud.<sup>8</sup>

Despite State Street’s consent to the \$25 million loan, its strong suspicion of Sharp’s fraudulent practices, and its refusal to take plaintiffs’ phone calls, the court dismissed the aiding and abetting claim for failure to state a cause of action.<sup>9</sup> State Street’s suspicion that Sharp was engaged in fraud was constructive, not actual, knowledge; and neither State Street’s consent to the loan nor its dodging of phone calls was enough to constitute “substantial assistance.” The court explained, “State Street had no duty of disclosure to plaintiffs because it had no fiduciary duty or other relationship with them, and did not even communicate with them in connection with” the loan.<sup>10</sup> Nor did State Street have superior knowledge of the kind that might give rise to a duty to disclose, because plaintiffs could have done the same investigations that State Street conducted.<sup>11</sup>

Courts in other jurisdictions have also refused to entertain claims by borrowers’ investors against the borrowers’ banks or other lenders. See *Glidden Co. v. Jandemora*, 5 F. Supp. 2d 541 (W.D. Mich. 1998) (holding bank’s mere silence and inaction insufficient to show substantial assistance in borrower’s fraud against investors); *Athey Prods. Corp. v. Harris Bank Roselle*, 89 F.3d 430 (7th Cir. 1996) (holding that neither bank’s failure to warn its borrower’s creditor about the borrower’s unstable financial condition, nor its continued extension of credit to borrower when it knew borrower could not meet its obligations to other creditors, could support plaintiff-creditor’s fraud claims); *Smith v. Am. Nat’l Bank & Trust Co.*, 982 F.2d 936 (6th Cir. 1992) (dismissing plaintiff-investor’s federal

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securities law claim for aiding and abetting fraud where defendant failed to disclose its borrower’s financial condition or the fact that the need for the bank’s loan arose from the borrower’s check-kiting scheme, because bank owed no duty to disclose information to which investor had equal access).

### Active Participation Required

One rare example of a case where the plaintiff stated a viable claim for aiding and abetting fraud demonstrates that in order to show sufficient actual knowledge and substantial assistance, the plaintiff must show that the defendant was nothing less than an active co-participant in the alleged fraud. In *Unicredito Italiano SPA v. JPMorgan Chase Bank*, 288 F. Supp. 2d 485 (S.D.N.Y. 2003), the court refused to dismiss an investor’s claim that the defendant banks had aided and abetted the fraud of Enron Corporation. The defendant banks, co-administrators of certain

Enron credit facilities in which plaintiff participated, allegedly engaged in “prepay” transactions with Enron, actively helping Enron to keep hundreds of millions of dollars in bank loans off its books.<sup>12</sup> Finding that defendants allegedly knew that these transactions would allow Enron to manipulate its public financial statements and that defendants’ alleged participation in the transactions contributed to Enron’s collapse, the court held that a legally sufficient claim was stated against defendants that they had substantially assisted Enron’s fraud.<sup>13</sup> Further, unlike the defendants in the cases discussed above, here the defendant banks purportedly made affirmative misrepresentations to plaintiff through offering memoranda and invitations to offer pointing plaintiff to public information about Enron that defendants allegedly knew to be false.<sup>14</sup> As a result, the court allowed plaintiff’s aiding and abetting claim to go forward.

### Conclusion

Unless a bank or other lender knowingly and actively participates in a fraud perpetrated by its borrower, the lender will not be liable to the borrower’s third party investors for aiding and abetting the borrower’s fraud. Moreover, even if a bank suspects that its borrower is engaging in fraudulent activity, the bank likely has no duty to disclose that information to third party investors.

1. *Jebran v. LaSalle Bus. Credit LLC*, No. 61057/2005 (N.Y. Sup. Ct. Jan. 17, 2006); *Albion Alliance Mezzanine Fund, LP v. State St. Bank & Trust Co.*, 8 Misc.3d 264, 797 N.Y.S.2d 699 (Sup. Ct.), aff’d 2 A.D.3d 162, 767 N.Y.S.2d 619 (App. Div. 1st Dep’t 2003).

2. *Unicredito Italiano SPA v. JPMorgan Chase Bank*, 288 F. Supp. 2d 485, 502 (S.D.N.Y. 2003).

3. *Jebran*, No. 60175/2005, slip op. at 2-4.

4. *Id.* at 5.

5. *Id.* at 5-6.

6. *Albion Alliance*, 8 Misc.3d at 265, 268, 797 N.Y.S.2d at 701, 703.

7. 8 Misc.3d at 265-66, 797 N.Y.S.2d at 701-02.

8. 8 Misc.3d at 266-68, 797 N.Y.S.2d at 702-03.

9. 8 Misc.3d at 273, 797 N.Y.S.2d at 707.

10. 8 Misc.3d at 270, 797 N.Y.S.2d at 704-05.

11. 8 Misc.3d at 270, 797 N.Y.S.2d at 705.

12. *Unicredito*, 288 F. Supp. 2d at 490-91.

13. *Id.* at 502.

14. *Id.* at 494.