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Client Alert

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Lenders' Duties when Enforcing Security

Against the backdrop of the Covid-19 pandemic and global economic slowdown, we are being asked by borrower and lender clients alike whether lenders have a duty of care as regards enforcement. Two recent cases before the English courts have brought renewed attention to the duties incumbent on lenders when exercising powers of enforcement. These cases underline the entrenchment of lender and agent rights under English law, and the relatively unconstrained ability of secured parties to pursue claims against defaulting borrowers.

MORLEY V RBS

In *Morley (t/a Morley Estates) v Royal Bank of Scotland Plc* [2020] EWHC 88 (Ch), a decision of January 2020, the Claimant, Morley (t/a Morley Estates) (**Morley**) (a property developer), had defaulted under a loan secured by a portfolio of properties, whose value had dropped significantly by the time of the default. The lender, Royal Bank of Scotland Plc (**RBS**), had previously exercised its right to charge interest at a higher default rate of interest, following Morley's breach of a loan to value covenant. Upon the principal payment default and following extensive negotiations, Morley and RBS entered into certain restructuring agreements, pursuant to which the bank agreed to release its security interest over five of the portfolio properties and sell those properties to Morley, in consideration for a £20.5 million payment. The remainder of the properties in the portfolio were to be transferred to RBS's subsidiary, and Morley was to be released from his obligations under the loan agreement.

Morley subsequently brought a claim against RBS, alleging that the bank had:

a. breached its duties (in tort and contract) to exercise reasonable care and skill in the provision of banking services;

b. breached its duty owed in contract to act in good faith and not for an ulterior purpose unrelated to pursuit of the bank's legitimate commercial interests asserting four breaches of the bank's implied duty to act in good faith (including obtaining a revaluation to "force" a breach of the loan to value covenant, to exert further pressure); and

c. the bank had tortiously intimidated him and subjected him to economic duress by threatening to appoint a receiver to sell off the entire portfolio as part of a pre-pack sale to a subsidiary of the bank, thereby securing Morley's consent to the restructuring agreements.

Morley claimed rescission of the restructuring agreements or damages in lieu. The court (Kerr J) dismissed Morley's claim in its entirety, holding that RBS had not breached the duties pleaded by Morley, and that there had been no intimidation or duress.

BREACHES OF DUTY BY THE BANK

Critical to the court's decision was the rejection of the proposition advanced by Morley that the loan agreement had "characteristics redolent of a joint venture or long-term relational contract"; a category of contracts in which the English Courts have been increasingly willing to imply duties of good faith (which has its genesis in decisions of Lord Leggatt, including *Yam Seng Pte Ltd. v International Trade Corporation Ltd* [2013] 1 Lloyd's Rep 526). The Judge disagreed: the loan agreement was an 'ordinary' loan facility agreement, and not a 'relational" contract, and so it was inappropriate to imply a duty of good faith. Even so, the Judge held that the contractual discretions in the loan agreement had to be exercised "*not so as to vex the claimant maliciously, nor for purposes unconnected to the bank's commercial interests*": a so-called *Braganza/Socimer* implied term under English law, that is analytically distinct from any general duty of good faith said to be implied by the nature of the contract. But RBS had not breached even this implied duty: in exercising its contractual discretion to charge default interest, rejecting Morley's offers and renegotiating the loan agreement the Bank had been acting "commercially".

INTIMIDATION/ECONOMIC DURESS

The court held that in the absence of bad faith, intimidation or duress could only be made out where the bank had threatened to carry out an unlawful act. No such unlawful threat was made out on the facts. Morley had in any case affirmed the restructuring agreements by failing to take any step to set them aside for more than five years after execution.

CNM V VECREF & ORS

In *CNM Estates (Tolworth Tower) Ltd v VeCREF I Sarl and others* [2020] EWHC 1605 (Comm), a decision of June 2020, the Claimant (**CNM**), had granted security over a high-rise building as collateral for certain senior (with CNM as borrower) and mezzanine (with CNM Estates (Tolworth Tower MB) Limited (**CNM MB**) as borrower) development financing. When CNM MB failed to make a payment under the mezzanine facility, an event of default was triggered under both facilities. The security agent duly appointed receivers who arranged the sale of the building. CNM subsequently brought a claim against (amongst others) the lender and receivers, alleging *inter alia* that the receivers had negligently breached their equitable duty to exercise reasonable care and skill in obtaining the best price reasonably obtainable for the secured asset. At trial of the preliminary issues, the receivers denied the breach and argued that the claims against them were precluded by exclusion of liability clauses in the debenture and intercreditor agreement. The court (Foxton J) ruled in the receivers' favour, ruling that the intercreditor agreement excluded their liability, save to the extent of any gross negligence or wilful misconduct.

DEBENTURE CLAUSE

Clause 19.1 of the debenture was found not to exclude the receivers' equitable duty of care implied as a matter of law, even if that duty could in theory be excluded by way of an exclusion clause. Applying three principles relevant to the construction of exclusion clauses, Foxton J held that the language of clause 19.1 was too general to exclude liability for actions taken in breach of the equitable duty (just as would have been the case for a purported exclusion of negligence): clause 19.1 sought only to exclude liability for "*any action permitted by this Deed*".

INTERCREDITOR CLAUSE

But Clause 16.10 of the intercreditor agreement was found effective in partially excluding the receivers' liability. The clause expressly provided that no liability would arise unless directly caused by gross negligence or wilful misconduct of the security agent/receiver. There was a sufficiently clear severity threshold, which precluded liability for acts of 'ordinary' negligence, and so also for acts in breach of the equitable duty.

COMMENT

These decisions, although different in the substance of their analysis, should be of comfort to lenders. They emphasise that the scope of lenders' rights to enforce security under English is generally unobstructed, and heavily dependent on the terms of the contract or loan agreement. *Morley* sounds a pragmatic note of caution in relation to the role of general obligation of good faith in this context, which would be difficult to apply to apply in practice to lenders' obligations under loan agreements in any event. *CNM Estates* emphasises that even where a general duty can be implied in law, the parties can agree to exclude it by the inclusion of sufficiently clear wording. Both decisions are useful reminders of the need to draft clauses in finance agreements with surgical clarity and precision.

But lenders must remain cautious, because of the finding in *Morley* that a so-called 'Braganza/Socimer' implied term applied to the lenders' contractual discretions in loan agreements. This is a novel and developing area of the law, which involves importing good faith obligations into the exercise of a specific contractual discretion. The case law suggests that it is carefully circumscribed, but again, this depends heavily on the contractual language, the circumstances of the parties, and the nature of the contractual discretion (it is more likely to be implied where one party has a right to make an assessment as to how the contract will be performed). Lenders must ensure that they act "commercially", rather than to "vex [the borrower] maliciously".

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