

# Lender's Liens Lost

by Richard S. Order

It has become an all-too-familiar story: a successful businessman finds himself without the cash flow necessary to keep his highly leveraged financial empire afloat, and his ability to make new deals is compromised.

He borrows money, readily agreeing to the terms of repayment because he expects that his latest transaction will easily enable him to repay the loan. Disaster strikes, his empire crumbles, he defaults on the loan, and the lender seeks to exercise his remedies with regard to the security. The businessman fights back by asserting the defense of "lender liability" on the grounds that the terms of the loan were unconscionable and that the security required by the lender was an unenforceable penalty contrary to public policy.

As a result of the recent banking crisis and the concomitant tightening of credit, lenders are exacting more stringent security terms, that is, when borrowers somehow manage to convince them to lend money. How far can lenders go in demanding security terms designed to provide a strong incentive for the borrower to pay and ensure full recovery upon default?

This issue is hardly new. In Shakespeare's *The Merchant of Venice*, Bassanio asks his friend, the wealthy merchant Antonio, for money so that he can properly woo Portia. Antonio, however, has overextended himself by outfitting trading ships on voyages throughout the world. Nevertheless, Antonio's credit rating is strong enough to borrow 3,000 ducats from Shylock. Needless to say, Shylock looks to Antonio and not the spendthrift Bassanio to repay the loan and provide security, which they agree shall be a pound of Antonio's flesh. When one of Antonio's ships is wrecked in the English Channel, he is unable to pay the loan when it comes due and Shylock commences an action for the security.

Should the security provision be enforced? In the play, Portia acknowledges that the provision should be

enforced but manages to rescue Antonio by invoking a Venetian law punishing aliens for even an indirect attempt on a Venetian's life. Throughout the play, though, Shakespeare touches upon certain fundamentals of contract law which we still follow today and which, when more fully analyzed, provide grounds for avoiding enforcement of the security provision.

Was the security provision unconscionable? It was a commercial loan, negotiated at arms length between sophisticated businessmen on equal footing. Since Shylock was not the only lender in town, Antonio could have turned to other lenders for better terms. Bassanio and Antonio, however, voluntarily approached Shylock, who did not attract them through advertising or a bait-and-switch scheme. To the contrary, they were aware of his reputation for making shrewd loans with harsh terms.

The terms of the security were not concealed in fine print but rather were openly discussed. In fact, Shylock even accommodated Antonio by refraining from his usual practice of requiring interest on the principal, a practice which Antonio condemned. Moreover, Antonio was so confident of his ability to repay the loan that he challenged Shylock to name a security suitable as a penalty to impose on an enemy.

Additionally, unconscionability of contract is an equitable defense subject to the clean-hands doctrine. Prior to the loan, Antonio had repeatedly humiliated, abused, and physically degraded Shylock. Antonio, therefore, was no innocent victim of overreaching worthy of extra protection from the courts.

Consequently, although the security provision allowing Shylock to cut off a pound of Antonio's flesh upon default clearly shocks the conscience, none of the other usual characteristics of an unconscionable contract is present. Accordingly, any defense by Antonio based on unconscionability of

contract should fail.

Antonio can, however, save his skin by arguing that the agreed-upon security cannot be deemed liquidated damages but rather a penalty contrary to public policy. While Shylock paid adequate consideration for the pound of flesh by lending the money and foregoing his usual interest, there were no real negotiations over the terms of the security and little evidence of an intention to liquidate actual damages in advance. More important, the pound of flesh had no relationship to the monetary harm which Shylock could reasonably have anticipated upon default. In fact, in an aside at the time the terms were agreed upon, Shylock acknowledged that a pound of Antonio's flesh would not even be worth a pound of beef, let alone 3,000 ducats. Finally, Shylock's damages upon default were not uncertain in amount or difficult to prove. Thus, the security lacked any of the usual traits of a liquidated damages provision and can only be deemed an unenforceable penalty contrary to public policy.

Although the security provision was unenforceable, Shylock was nevertheless entitled to recovery of his actual damages of 3,000 ducats. If Shakespeare's twist had not ruined him, he would have at least recovered the principal of the loan since Antonio's other ships eventually arrived laden with profit. Not all lenders are so fortunate. ■

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