LENDER LIABILITY: PITFALLS AND HOW TO AVOID THEM

By Mark Clairmont
GERSON LAW FIRM APC

March 2009

In today's declining real estate market, it is unavoidable that once viable and profitable real property investments will fail. With those failures, will come increased loan defaults and problem loans. While this cannot be avoided, Lenders can take steps to reduce and avoid their potential liability to their borrowers.

We have observed that this current downturn in the market is different from that experienced in the 1990's. In the prior downturn, borrowers would often file a bankruptcy to slow down the foreclosure process or force a workout. Now, we are seeing many more borrowers allowing the properties to be foreclosed upon, choosing to fight their battles at the guarantor level. Furthermore, investors and developers often carry with them the mentality that they have no personal liability for a defaulted loan, even if they have executed personal guarantees. As such, we predict that guarantors will be fighting back and exploring personal bankruptcy options. However, bankruptcy rules have changed and many have already exhausted their bankruptcy options prior to the recent code revisions. As such, the major battles will likely be waged in our state courts and the weapon of choice for borrowers will become lender liability. As such, Lenders must ensure that enforcing their loans and personal guarantees will not bring more harm than good. Once a lender files an action to enforce personal guarantees it is common for the guarantor to file a cross-complaint against the lender asserting various defenses and alleging lender misconduct. The following will explain the common pitfalls that lenders may find themselves in and the ways to avoid those pitfalls.

1. <u>Breach of Contract</u> – A borrower may assert that the lender has failed to perform its legal obligations under the loan documents. The lender must strictly follow the terms of the loan documents and any deviation from the loan documents could potentially expose the lender to liability.[1] Further, care must be taken to ensure that the loan documents have not been superseded by a subsequent contract.[2] Lenders must also take care to notify the borrower of any material change in the lender's conduct or of enforcement.[3] As such, before taking any material action, lenders must

---

[1] Perdue v Crocker National Bank (1985) 38 Cal.3d 913; Fischer v First International Bank (2003) 109 Cal.App.4th 1433; Sahadi v Continental Ill. National Bank & Trust Co. (7th Cir 1983) 706 F2d 193; Brown v Avemco Inv. Corp. (9th Cir 1979) 603 F2d 1367.
[2] U.S. Hertz, Inc. v. Niobrara Farms (1974) 41 Cal.App.3d 68.
[3] K.M.C. Co. v Irving Trust Co. (6th Cir 1985) 757 F2d 752.

always reference the loan documents and carefully consult with competent and experienced counsel.

2. Breach of Implied Covenant of Good Faith and Fair Dealing – Related to contract law and implied in every contract, Lenders are required to deal with borrowers in a fair and open manner and in good faith.[4] As such, lenders must avoid any conduct that contains an air of impropriety, dishonesty or duress. However, this legal concept cannot prevent a lender from properly exercising its rights under the law and the loan documents.[5]
3. Negligence – A borrower may also claim that the lender has negligently administered the loan, thus causing the lender's own loss.[6] Here, it is critical that the loan has been administered in strict accordance with the loan documents and the law.
4. Fraud/Misrepresentation – A borrower may argue that oral and/or written representations by the lender induced the borrower to rely on such representations to their detriment.[7] It is critical the lenders avoid making representations to borrowers that could be misconstrued at a later time. Also, lenders should refrain from giving business or investment advice and should avoid engaging in excessive and/or unnecessary letter writing campaigns with borrowers.[8] The less a lender states to the borrower, the better.
5. Waiver of Default/Lulling – Borrowers will often argue that any defaults have been waived by the lender and that the borrower was lulled (by the lender's actions) into believing that the lender would not be filing a lawsuit or pursuing a deficiency. Accepting late payments without a reservation of rights, keeping the borrower in the dark, negotiating a workout with no real intention of agreeing to such a workout are some examples of actions that may later prove to be detrimental to the lender.[9]
6. Collusion/Bid Chilling in Foreclosures – Civil Code section 2924h(g) prohibits any type of collusion or bid chilling with regards to the competitive bidding process. As such, when foreclosing, lenders must refrain from negotiating with any potential buyers or junior creditors until after the actual sale.[10] Violation of this statute carries a stiff penalty of up to one year in county jail and a fine up to $10,000. CC §2924h(g).
7. Waiver of Guarantees – Although virtually all standard guaranty forms used today contain an authorization allowing the lender to change the loan terms without notice to the guarantor and without reducing or eliminating the guarantor's liability to the lender, any modification, extension, settlement or workout of a loan without the express written affirmation of all guarantors unnecessarily risks leading to an inability by the lender to

---

[4] Perdue v Crocker, supra; Egan v Mutual of Omaha Ins. Co. (1979) 24 Cal.3d 809.
[5] Carma Developers, Inc. v Marathon Dev. Cal., Inc. (1992) 2 Cal.4th 342
[6] Connor v Great W. Sav. & Loan Ass'n (1968) 69 Cal.2d 850.
[7] Fischer v First International Bank (2003) 109 Cal.App.4th 1433.
[8] Connor v Great W. Sav. & Loan, supra.
[9] Lopez v Bell (1962) 207 Cal.App2d 394.
[10] Russel v Soldinger (1976) 59 Cal.App.3d 633; Gonzales v gem Props. (1974) 37 Cal.App.3d 1029.

enforce said guarantees.[11] As such, it is critical that any change in the loan terms must be consented to in writing by all of the guarantors. Furthermore, the loan and the guarantees must also be affirmed in writing. However, lender's forbearance to accelerate or to enforce any of its remedies against a borrower is not equivalent to a modification or extension of the loan.[12]

8. SEC Violations – Soliciting memberships in an entity that will hold property and soliciting participating in an investment can be considered a securities matter and appropriate initial steps must be taken by the lender to ensure that no SEC regulations are violated.[13]
9. Improper waivers of anti-deficiency and other statutes – Borrowers and Guarantors are afforded many protections in California. However, most of those protections may be waived, if the proper statutorily prescribed language is used and consented to. Many loan document forms currently being utilized by lenders are deficient in this regard and will impair a lender's ability to enforce a guaranty after a non-judicial foreclosure. As such, it is critical that all loan documents and guarantees be reviewed by counsel familiar with the applicable statues and that proper statutory waiver language is utilized.
10. Wrongful Control and Interference – Lenders, especially with regards to construction loans, must be careful to never become an operator or partner in development projects. A lender must remain merely a lender. Avoid the temptation to advise the borrower or help the borrower with any decision making with regards to the project. When a construction loan does go bad, one of the first actions of a borrower will be to blame the lender for turning off the tap and interfering with the construction or inhibiting it.[14]
11. Receivers – If a receiver has been appointed, understand that the receiver does not work of the lender and cannot take any direction from the lender. Rather, the receiver is a neutral third party that is actually an officer of the court and controls the asset for the benefit of all that may have an interest in that asset(s). Should a receiver take direction from any of the parties involved, other than the court, the receiver and the lender could potentially be exposed to liability.
12. Chain of Title Liability Issues – Lenders should also carefully analyze the choice to take back a property through foreclosure, deed in lieu of foreclosure or other method. Once a Lender is placed into the chain of title, the lender could (under state and federal laws) become liable for potential problems with the property relating to construction defects (in the case of an unfinished project), hazardous waste or other soil contamination (in the case of gas stations and similar properties),

[11] V.I.P. Agency v Duffy Elec., Inc. (1979) 92 Cal.App.3d 849; Wexler v McLucas (1975) 48 Cal.App.3d Supp 9.
[12] Southern Cal. First Nat'l bank v olsen (1974) 41 Cal.App.3d 234.
[13] 15 USC §77o; 15 USC §78t(a).
[14] Connor v Great W. Sav. & Loan, supra; Kinner v World Sav. & Loan Ass'n (1976) 57 Cal.App.3d 724.

especially if the lender participated in the management of the construction and/or handling of hazardous substances and environmental compliance.[15] An investigation must be undertaken by the lender (and possibly a Phase I environmental analysis obtained) and advice sought as to when it is appropriate to take title to a particular property, when to abandon it, when to appoint a receiver to take control and when to set up another entity to take title to the property. While Federal legislation enacted in 1996 has sought to limit the liability of lenders for such environmental concerns, lenders still face potential liability and should seek the advice of counsel to assist in determining the best course of action.

13. <u>Statutory Liability</u> – There are many statutes that may afford a borrower a basis for recovery should a lender violate such a statute. For example, recent case law has upheld a lender's obligation to comply strictly with the Truth In Lending Act's disclosure requirements with respect to residential real property and consumer credit transactions.[16] Failure to do so can expose a lender to rescission of the violating loan transaction and liability for damages, attorney's fees and costs. Other statutes governing environmental hazards, securities, antitrust, bankruptcy, settlement fees and procedures, discrimination, taxes, consumer protection, fair housing, racketeering, usury and others all have the potential to create liability traps for the unsuspecting lender.
14. <u>Fiduciary/Special Relationships</u> – While recent case law has indicated that there is no fiduciary relationship between a lender and its borrower in an ordinary commercial transaction, Lenders must still be careful to avoid possibly creating a fiduciary relationship between the lender and borrower that could give rise to a constructive fraud action.[17] In the past, courts have explained that a fiduciary relationship may arise if there is evidence that the lender gave business advice to the borrower, had a personal interest in the borrower's action on any advice given by the lender and caused the borrower to rely on lender's business advice.[18]
15. <u>Predatory Lending</u> – While usually only associated with residential lending, similar concepts under the law do apply to the commercial sector as well. Lenders must be careful to not charge and collect inappropriate fees and costs and avoid "steering", "yield spread premiums", approving loans to borrowers that have no hope of repaying them, excessive impounding of interest, excessive penalties, unrealistic appraisals and other similar actions.[19]

---

[15] 42 USC §9601(20)(E)-(G); KFC Western, Inc. v Meghrig (1994) 23 Cal.App.4th 1167; U.S. v Fleet Factors Corp. (11th Cir 1990) 901 F2d 1550.

[16] Pacific Shore Funding v Lozo (2006) 138 Cal.App.4th 1342, 1355.

[17] Price v Wells Fargo Bank (1989) 213 Cal.App.3d 465; Kim v Sumitomo Bank (1993) 17 Cal.App.4th 974.

[18] Barret v Bank of America (1986) 183 Cal.App.3d 1362; Commercial Cotton Co. v United Cal. Bank (1985) 163 Cal.App.3d 511.

[19] Auerbach v Great W. Bank (1999) 74 Cal.App.4th 1172.

16. Mortgagee/Lender in Possession - A mortgagee in possession is defined as a secured creditor who accepts possession of the real property security without obtaining title to the property. Typically, this may occur when a lender takes possession of a property prior to a trustee's sale. A creditor that obtains mortgagee in possession status may become responsible for the management and maintenance of the property and can be liable to the borrower for any mismanagement. While California Civil Code Section 2938 has greatly reduced the risk that lenders will fall into this trap, all lenders must take care to exert as little control as possible over a property until after it obtains ownership through either foreclosure or a deed in lieu of foreclosure. Lenders should limit their activities to merely collecting the rents and abating any urgent health and safety issues.

A point to remember is that when such a lender liability case comes before a court, the lender's duties and obligations will be determined by an analysis of the entire lender/borrower relationship and not merely on the loan documents alone. As such, lenders must carefully monitor the administration of its loans and carefully train its officers that engage in the day to day administration of these loans.

A workout or forbearance is a great opportunity to correct and mitigate some lender liability issues, if known. Any guarantees must be affirmed and the borrower must release the lender and waive any defenses that may exist. Obtaining a stipulation from the borrower to have a receiver appointed to collect rents and later take over the property in the case of a subsequent default may also be prudent. Essentially, the lender may attempt to improve its position from a legal and business perspective.

Hiring an experienced attorney to: (1) analyze the loan documents and borrower/lender relationship, (2) identify potential lender liability issues, (3) advise lender as to possible mitigation steps, (4) assist with a workout or forbearance and (5) assist with a foreclosure or other enforcement action will go a long way in avoiding the common lender liability pitfalls and ensuring a quick and cost effective recovery for the lender.

Mark M. Clairmont, Esq.