What You Can Do to Avoid Liability Claims

Staying out of court often entails proper handling of borrowers and their loans

By **Steven I. Fried,** principal, Capital Finance

Lender liability is a catch-all phrase used to describe several theories under which a lender can be sued for doing or not doing something in connection with a loan or loan commitment. Allegations can involve violations of an implied or contractual fiduciary duty to a borrower or to its creditors or shareholders.

Although there are many variations on these types of suits, particularly in the wake of the housing slowdown and increase in subprime-loan (aka, nonprime-loan) defaults, litigation usually is extensive and expensive. Further, lenders also can shift some blame to brokers via terms of brokers' contracts with lenders, or brokers could face similar allegations themselves.

There is no ironclad way to avoid a claim or lawsuit involving liability. But by following the right steps when making or restructuring loans, brokers and lenders can better assess or avoid liability claims.

Here are some of the most-common issues that arise in claims or litigation involving lenders. In addition to understanding factors that are common to any claim of lender liability, residential brokers also might be wise to recognize areas of specific concern to subprime loans — and some common-sense tactics.

Common issues

Although each case has its own set of characteristics and circumstances that brokers and lenders must examine in context, most liability claims can boil down to factors surrounding these issues:

- **Commitments:** Some state laws require that a "promise" to lend must be in writing when the loan exceeds a certain amount. This is your first chance to avoid lender liability. Your loan agreement should be in writing and be as detailed as possible. Spell out exactly to what you did and did not agree. More important, specify what would invalidate the commitment. Relying on a material-adverse-change clause or other types of "dragnet" clauses that are open to interpretation can be dangerous.
- **Documentation:** Rather than referring to loan documentation, this entails notes and memos you place in the customer's file. When a financial transaction goes bad, everyone's motives and due diligence fall into question — no matter how well-intentioned your actions were meant to be. The implied covenant of good faith and fair dealing, undue influence, deepening insolvency and breach of contract can be turned one way or another based on how well-documented the file is. As a broker, remember to keep it clean — just include the facts. Leave out any emotional or personal observations. Remember: If you place something in a customer's file, be prepared to read it aloud in a courtroom.

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- **Servicing:** The lender has a duty to process any loan application or loan with reasonable care. Negligent calculation of the applicant's qualifications might induce a cause of action against the lender for failure to use proper due diligence. Lenders also have an obligation to service each loan properly. This is particularly common in construction or asset-based loans, where the lender has a continuing role. It also can be important in loan modifications, workouts and liquidations.
- **Confidentiality:** This is becoming an issue in more claims. Disclosing unnecessary financial information about someone's affairs while making or collecting a loan is especially volatile and serious, considering privacy laws. Make sure that any public disclosures are absolutely legal and necessary. Handle any attempt to value or liquidate collateral with extreme care.
- **Fraud:** Generally, fraud is not an issue connected to lender liability. But fraud is a double-edged sword. Lenders and brokers can face fraud accusations, which can be lumped in with liability. This occurs when a party is damaged as a result of a broker's or lender's material representation that is known to be false. This kind of representation can include promising to make a loan or agreeing to restructure one when there is no present intention to do so. This can expose the broker and lender to actual and punitive damages.
- **Change:** Don't change any of your major processes without adequate notice or reason. This includes how you interpret loan documents, handle defaults or engage in any similar behavior.

Subprime-liability snags

In addition to the areas common to all loans, there are a number of issues that come up with subprime loans of which brokers and lenders should take heed to avoid liability claims. Pay attention to:

- **Intermediaries:** Although this is not exclusive to subprime loans, it is more prevalent in the subprime market. Know where the loan is coming from, and ask the following of everyone who handles it:

– Are sales and underwriting staffs properly trained?

– Do they have adequate internal controls to discourage mistakes in preparing and submitting loan packages?

– Is everyone clear on the underwriting guidelines?

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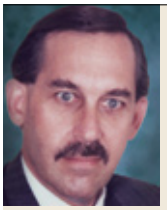

Steven I. Fried is a principal at Capital Finance, a litigation-consulting and support firm specializing in complex banking and commercial finance matters. Reach him at (760) 776-5749 or steven.fried@bankingexpertwitness.com or via www.bankingexpertwitness.com.

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– Has the prospective borrower received appropriate disclosures and an accurate explanation of the transaction's benefits and risks?

– Are loans periodically checked for quality control and compliance?

– Does your financing source have strong standing? Is it licensed and experienced?

Beyond the risk of losing the principal, there is an increasing trend toward holding the lender responsible for any actions of a broker or mortgage banker, as well.

- **Duress:** Don't tell borrowers how to run their affairs. You should provide as much unbiased information and education as you can, but pushing the other side into making a particular choice can be considered duress, undue influence or interference. If things don't work out, any advice a broker or lender gave can be seen as attempting to impose a course of action against the potential borrowers' judgment.

- **Compensation:** Lenders should examine their compensation schedules carefully. If a loan or loan pool experiences difficulty, courts could look at anyone in the origination chain who had a financial incentive to act a certain way. Any specific compensation, such as front-end, back-end or yield-spread premiums, in addition to bonuses, will face scrutiny for evidence of conflict or clouded judgment.

- **Interference:** This can be related to a duress claim and several others. Lenders should not attempt to sell real estate collateral in which they have no equity interest. Many lenders have made this mistake when trying to sell collateral, especially the kind of real estate collateral seen in subprime loans. The most common example is when a lender attempts to sell collateral on which a foreclosure process is not yet finished. Although there is the temptation to help a troubled borrower or for lenders to move a nonperforming loan off their balance sheet, any prospective purchaser for the lender also is a prospect for the borrower. Any communications regarding the collateral before full foreclosure could spur an interference claim and should be handled with care. If you decide to help borrowers sell collateral before the foreclosure process is finished, talk to an attorney and consider a legal and enforceable waiver.

Using common sense

All borrowers have individual circumstances and cannot be viewed out of context. Once you know the facts, ask yourself one simple question: "Would I recommend the actions I'm offering if I were dealing with a family member in a similar situation?"

In other words, employ common sense.

One thing to avoid is a "neutron loan." Like a neutron bomb, this destroys the borrower but leaves the collateral standing. Some lenders do specialize in "loan to own" scenarios and receive the corresponding compensation. Priced into those loans are the costs of extended bankruptcy, deferred maintenance, foreclosure, declining collateral values, reputation risk and legal fees. Unless you are prepared to assume these risks, stay away.

Some institutions also hold the originating lender responsible for decisions on nonperforming or poorly performing loans, while others transfer the responsibility to a special troubled-loans department. Each approach has its pros and cons. Whichever alternative you face, if you are concerned about liability in the transaction, always speak with knowledgeable counsel.

Anti-deficiency statutes also are worth considering when you face nonperforming loans. In some states, these protect borrowers from having to pay the difference between the outstanding loan balance and the sales price of a home, should the lender take title to it. This protection often applies to first mortgages, rather than to seconds. In other cases, such as short sales, any potential deficiency balance may be subject to negotiation where the issue is not a matter of law. Be prepared that any denied request to waive a deficiency balance might result in a liability claim. These claims can be complex and expensive, and they often bring industry standards of practice and conduct into the conversation.

If you're instead modifying a loan, also consider new laws, which vary by state. Again, document everything you do in the context of what you did, why you did it, who requested it and what promises either party made. Don't run afoul of new disclosure requirements. Ensure there are appropriate consents from investors or junior-lien holders. If foreclosure is necessary, make sure you have all your loan documents. In this era of pooled loans, securitizations and subservicers, courts are taking an increasingly dim view of partial or incomplete proof.

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Although there are other areas in which brokers and lenders can be held liable, knowing the most-common issues can help both sides prepare. As with most legal situations, it's also advisable to consult with an attorney to sort out these complex issues.

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