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All the predictions are for a flood of upcoming lender liability litigation surrounding real estate lending in general and particularly sub-prime lending. The rules are also changing at lightning speed. This article addresses some of the known and potential issues as of this writing.

Avoiding Lender Liability in Sub Prime Loans

I want to start off by saying there is no ironclad way to avoid a claim or lawsuit involving lender liability or any other potential litigation. All any lender can do is follow the right steps in making or restructuring a loan.

This article outlines the most common issues I have seen in my years reviewing claims or litigation where a lender was a party to the dispute. The article is divided into three parts: those issues common to any claim of lender liability, areas of specific concern to sub-prime lenders, and common sense.

Lender liability is a catch-all phrase used to describe several theories under which a lender may be sued for doing something or not doing something in connection with a loan or loan commitment. AmericanBanker.com defines it as "An informal term referring to various manifestations of actual or potential legal liability arising from the conduct of a financial institution lender. Generally, lender liability arises from allegations that a lender has violated a duty (whether implied or contractual) of good faith and fair dealing owed to the borrower or has assumed a degree of control over the borrower resulting in the creation of a fiduciary duty owed to the borrower or its other creditors or shareholders." Within this definition are numerous variations, interpretations, and completely new causes of action. Some of these new causes of action are gaining acceptance particularly because of the difficult economic circumstances the country is currently facing.

If litigation arises in this area, it is usually extensive and expensive. So, what are the factors to consider in assessing or avoiding lender liability? What follows is not an all-inclusive list, but some of the most common issues arising in lender liability lawsuits. Each case has its own set of characteristics and circumstances that must be examined in context.

Factors Common to All Loans

Commitments – Some states have laws requiring that a "promise" to lend (over a certain amount) must be in writing. This is your first chance to avoid lender liability. If you have agreed to lend money, you should put it in writing and that writing should be as detailed as possible. Spell out exactly what you did and did not agree to. Perhaps more importantly, you should specify what would cause you not to go ahead with the commitment. Reliance on a material adverse change clause or other types of "dragnet" clauses (in commitments or loan documents) are subject to lots of interpretation and fraught with danger.

Documentation – Document, document, document. I am not referring to loan documentation here but to notes and memos you should place in the customer's file. This tip has a bearing on just about every aspect of lender liability. When a financial transaction goes bad, everyone's motives and due diligence will be questioned. No matter how well-intentioned your actions were meant to be, they will be questioned if things don't go as everyone expected. The implied covenant of good faith and fair dealing, undue influence, deepening insolvency and breach of contract all can be turned one way or another based upon how well documented the file is. Yes, document, but keep it clean. Just the facts. Leave out any emotional or personal observations. Everything you put in a customer's file you might be reading out loud in a courtroom.

Change – Don't make any sudden changes in the pattern of dealing. Whether it relates to the payment or acceptance of checks, interpretation of loan documents, defaults or any other behavior that is established; don't change what you have done in the past without adequate notice or reason.

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. Once a loan is made, the lender has an obligation to service it properly. This is particularly common in loans where the lender has some continuing role such as construction or other asset-based loans. It may also become an important issue during modifications, workouts, and liquidations.

Confidentiality - There are an increasing number of claims involving confidentiality. The right to financial privacy and other laws make the disclosure of unnecessary financial information concerning someone's affairs in the making or collecting of a loan especially volatile and serious. Make sure that any public disclosures are absolutely legal and necessary. Any attempt to value or liquidate collateral should also be handled with extreme care.

Fraud – I mention fraud only in passing. It generally is not an issue that one normally connects with lender liability but fraud is a two-edged sword. Lenders can be accused of fraud, in which case it is also lumped in with lender liability. This cause of action will be found when a party is damaged as a result of a lender's material representation that is known to be false such as promising to make a loan or agree to a restructure when there is no present intention to do so. This cause of action exposes the lender to both actual and punitive damages.

Factors Specific to Sub-Prime

The factors mentioned above as common to all loans, to the extent they apply to any loan, would also apply here. It should also be noted that many of the issues that follow would apply to almost any real estate secured loan.

Channel Checks /Application Origination – Even though it is not exclusive to sub-prime loans, it is much more prevalent in the sub-prime market that lenders receive loans or loan applications through one or a series of intermediaries. Know your source!

Does each referral source have sales and underwriting staffs that are properly trained? Are their internal controls adequate to discourage mistakes in the preparation and submission of loan packages? Have you provided the referral source with your underwriting guidelines? Has your referral source provided an applicant with all appropriate disclosures and accurately explained to a prospective borrower exactly what the benefits and risks of the transaction are? Last and most important; do you periodically test check loans submitted from each referral source for quality control and compliance?

Does the source of the transaction have financial standing? Is the source licensed? How long have they been in business? Does the source of the loan referral have adequate finances to withstand the inevitable charge-backs or counter-claims? Beyond the obvious risk of losing the principal, there is an increasing trend toward holding the ultimate lender responsible for any actions of a loan broker, wholesaler or mortgage banker.

Duress – Don't tell the borrower how to run their own affairs. You should provide as much unbiased information and education as you can, but don't push the other side into making a particular choice. Whether it's called duress, undue influence, or interference, if things turn out badly, any advice you gave (by internal staff or a broker), can be seen as attempting to impose a course of action against the judgment of the other party.

Compensation – Lenders should examine their compensation schedules carefully. An issue that, invariably, will come up if a loan or pool of loans experiences difficulty is a question of whether anyone in the origination chain had a financial incentive to take (or not take) a particular action. Any sort of specific compensation such as premiums (front-end, back-end, yield spread, or other) or bonuses will be scrutinized for evidence of conflict or "clouded" judgment.

Interference – This can be related to a duress claim and several others as discussed above. I have mentioned it here because I have seen numerous lenders make this mistake when trying to sell collateral, especially real estate collateral and the kind of real estate collateral usually seen in sub-prime loans. You should not attempt to sell real estate collateral in which you have no equity interest. The most common example of this is when a lender attempts to sell collateral which has not been fully foreclosed upon. Although the temptation to "assist" a troubled borrower or move a non-performing loan off the balance sheet is great, any prospective purchaser for the lender is also a prospect for the borrower. Any communications regarding the collateral by the lender prior to full foreclosure may give rise to a claim of interference and should be handled extremely carefully. If you decide to help a borrower in selling collateral prior to fully foreclosing on collateral; consult with counsel and/or obtain a legal and enforceable waiver.

Common Sense

All borrowers and all loans have their own unique set of circumstances and can not be viewed out of context. Once you have a full and complete understanding of the facts and circumstances, ask yourself one simple question. Would I recommend the actions being offered to a close family member who is similarly situated?

Stay away from "Neutron Loans." A neutron loan, like a neutron bomb, destroys the borrower but leaves the collateral standing. There are lenders who specialize in "loan-to-own" and get compensated accordingly. Priced into those loans are the costs of extended bankruptcy, deferred maintenance, foreclosure costs, declining collateral values, reputation risk, and legal fees. Unless you are prepared to assume these risks, stay away.

Some institutions have a policy of making the originating lender responsible for decisions on non-performing or sub-performing loans while others transfer the responsibility to a special department for such loans at the first sign of trouble. Each of these policies has its pros and cons. Whichever alternative you face, if you are concerned that lender liability might be an issue in your transaction, always speak with knowledgeable counsel. Counsel who is experienced in these types of actions may tell you the claim has no merit, analyze the claim and suggest a compromise, or tell you to settle.

Another factor to consider when a loan becomes "non-performing" are anti-deficiency statutes. Certain states, for certain types of loans, have anti-deficiency statutes. In other cases any potential deficiency balance may be the subject of negotiations where the issue is not a matter of law such as short sales. Be prepared that any request to waive a deficiency balance which is denied might result in a lender liability claim. These claims can be complex, expensive, and involve industry standards of practice and conduct.

While this article focuses on lender and borrower behavior rather than mistakes in the actual documentation for a particular loan, the current wave of loan modifications requires some discussion of documentation to consider when modifying a loan. In addition to everything we've discussed above, when modifying a loan, also consider the following since any of these mistakes might lead to a lender liability claim down the road. Laws have changed and sometimes vary State by State. Again, document everything you do in the context of what you did, why you did it, who requested it, and what promises were made by either party. Don't run afoul of new disclosure requirements. Make you sure you have appropriate consents from investors or junior lien holders. If foreclosure does become necessary, make sure you have all of your loan documents. In this era of pooled loans, securitizations and sub-servicers, the courts are taking an increasingly dim view of partial or incomplete proof.

This summary is certainly not all-inclusive on the issues of lender liability. It merely represents some of the most common issues. If confronted by a particular situation, as always, we are available to help you sort through these complex issues.

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