The Avoidance of Lender Liability Claims

Checklist of Issues/Due Diligence

I. Avoiding "*Classic*" Lender Liability Claims, Brought By A *Borrower* In Connection with the Administration of Making of A Loan

The following suggestions relate to the period *after default* and when a workout is being contemplated:

a. Many commentators suggest that, after default, outside counsel who closed the loan should *not* handle the workout; they should be *replaced with counsel expert in workout and lender liability*.

Lawyers have an understandable loyalty to their work product. This can cause several problems, including (i) closing counsel may refuse to acknowledge inherent *weaknesses* in the documentation that need to be addressed, and perhaps fixed, as part of the workout, and (ii) the closing lawyer may counsel the lender to interpret and enforce the loan agreements *strictly*, when courts today are increasingly *reluctant* to hold to the strict letter of agreements.

b. Similarly, administration of the loan in many cases should be *moved* from the current loan account officer and given to a *new "workout" officer* who is not tied to the borrower and can view the borrower, and the file, with *objectivity*.

c. The original loan account officer should be fully *debriefed* regarding the loan file, with attention paid to: (i) the question of whether any "*oral waivers*" or agreements may have been made or suggested, (ii) the status of the construction/condominium, and (iii) the overall relationship with the borrower.

d. The *loan documents should be reviewed* completely to insure that they are all fully executed, complete and to determine whether there are any deficiencies in the terms of the loan documents that may be troublesome later on.

e. The workout officer should *document every communication* and agreement with the borrower and any guarantors. Set a complete *record* of everything that transpires.

f. Avoid reliance upon *immaterial* or "non-monetary" defaults in accelerating a loan or in refusing to make advances.

g. *Avoid "sudden moves"* that might adversely affect the borrower's project and avoid adhering too closely to the exact letter of an agreement. While you may have the right to default the borrower the day after a payment is missed, giving the borrower some extra time, to get back to performing status, may set a *record of "good faith"* that could be valuable later on.

h. Be careful with the *tone* of default letters and written communications, *avoiding "saber rattling"* and "tough talk" that may not be appreciated by a jury (outside

counsel should take care here as well). One commenter suggests being "accessible and professional" with a professional and non-emotional demeanor at all times.

i. Be careful in internal communications, emails and memoranda to colleagues, resisting the temptation to *name call* or denigrate the borrower. Be careful of any suggestion of seeking to "get rid" of the borrower.

j. Refusing to make an advance in a construction loan, can lead to adverse consequences for the borrower; *Err on the side of making the advance*, even if an issues exist, but carefully document and make a record of all the extant issues so that the borrower cannot claim "waiver" later on.

k. *Do not interfere with the borrower's business* or involve yourself too closely in the day-to-day decisions in the construction project. Make sure your inspectors and agents understand this as well. Similarly, avoid making "suggestions" to your borrower about what to do, or what not to do.

l. Always be *truthful to third parties*, such as potential replacement lenders, or contractors. As a general rule, to the extent possible, *avoid contact with third parties* and provide no assurances. If a borrower makes a misstatement in front of third parties, and lender is present, it must correct the record.

m. When a workout strategy has been decided upon, set up a meeting with the borrower, but before meeting jointly execute a "*Negotiation Without Prejudice Letter*" making clear that no waivers are being granted and that any agreement will have to be in a signed writing.

n. As part of any forbearance or workout agreement, be sure to obtain a *general release* from the borrower (and guarantors) so as to avoid later claims of lender liability; also, use to opportunity to fix any defects in the loan documentation.

In some instances, the *entire goal in the workout will be to get that release* – it may be worth granting the borrower a forbearance or other concessions so as to lock up a release of potential lender liability exposure.

o. Always operate in "good faith," or as one authority has stated it: *Just "be fair."*

II. Avoiding Lender Liability Claims Brought By *Third Parties* In Connection with the Administration of Making of A Loan *Before* Foreclosure:

The following suggestions relate to the period *before* taking possession, and avoiding liability to third parties:

a. While liability in this area is not common, some case law warns that a lender should *not* "exert either *direct or indirect control* over the Developer" during any time while units are being marketed, sold or transferred to unit owners.

b. What is acceptable action falls along a continuum:

On one end, a lender steps over the line where it is deeply involved (i) in all aspects of *planning* the project, (ii) of *selecting the general contractors* or other construction experts, or (iii) in taking too much of a role in the *day-to-day decisions* about the construction and the project.

On the other end, "*The approval of plans and specifications and periodic inspection of houses during construction is <u>normal</u> procedure for any construction money lender*."

III. **Post-Foreclosure: Avoiding Lender Liability Claims Brought By Third Parties After <u>Foreclosure/Deed-in-Lieu</u>**

a. Most importantly, a Lender must consider this question very carefully:

Should we take possession and complete the condominium, or should we take other action, so as to avoid liability to third parties?

Alternatives include, (i) granting *forbearances* and allowing the *developer to finish the projec*t, or (ii) taking possession and *selling the project* to another developer (or selling the paper), or (iii) taking possession and either "mothballing" the project, until a new developer can be located, or *taking it out of the condominium regime altogether*.

b. The answer to this question will depend upon the relevant law in the jurisdiction and completing extensive due diligence at the time this decision is made. Among the many factors to consider, the following issues are particularly important:

i. Has the project been completed, or will the lender be engaged in substantial construction? How about important common elements, such as a health facility or pool, are they complete?

ii. How many units have been sold?

iii. Check to see if the developer has made any false or misleading statements; Among other things check (A) the offering plan, (B) advertising, (C) exhibits to offering plan, (D) budgets, (E) contracts of sale, etc.

iv. Does the project comply with all the promises or "puffing" by the developer? Is it a "*luxury*" project"? Are you ready to supply all the amenities promised by the developer?

v. Check all aspects of construction for construction defects, getting engineering and expert reports as needed. Review all extant reports.

vi. Environmental – always a key concern.

vii. Consider whether an option is to complete the project but take it out of the condominium regime, with its regulatory oversight and potential for claims by unit owners and the condo association.