



*presents*

# Lender Liability: Evaluating, Minimizing and Defending Claims

## Defending Against Attacks on Loans in Workout, Default and Bankruptcy

**A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

W. Mike Baggett, Chairman Emeritus, **Winstead**, Dallas  
Steven I. Fried, Principal, Capital Finance, **Indian Wells**, Calif.  
Mark J. Kalla, Partner, **Dorsey & Whitney**, Minneapolis

**Tuesday, March 16, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

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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.

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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. 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

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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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## Five Mistakes Attorneys Make After Deciding To Hire An Expert

I try to stay as current as possible on developments in my little corner of the world and it struck me recently that not much new has been written on a subject that is so important to the financial lives of many people. Financial litigation is frequently complicated, expensive and usually there is a lot at risk. After working in the Banking Industry for more than 32 years, the last 20 or so of which acting as a turnaround specialist for “troubled” banks; I have had more than my fair share of working with debt resolution, loss mitigation, banking litigation, attorneys, depositions and court appearances. It was, in part, that very experience that caused me to begin consulting or testifying for attorneys on finance related matters.

Working with attorneys in recent years when I wasn’t a party to the litigation has been a real eye-opener. Before continuing, I have to add that the vast majority of attorneys in cases where I have been retained have been exceedingly bright, talented, knowledgeable and quick studies of what can sometimes be very complex financial transactions. The eye-opener part; however, has been some common mistakes they make in picking and utilizing an expert consultant or witness.

### Picking The Right Expert

My focus, in this area, is on the background credentials of the expert. I assume that any expert retained by a law firm will make a good appearance and speak well enough. Today, more than at any other time, many cases are won or lost on the testimony of the expert witness. The real difference between an expert that will help make or break your case is the depth and diversity of the expert’s background within the industry involved in the litigation. I specialize in financial institution matters yet I have seen opposing counsel try to qualify CPA’s or mortgage brokers as their expert. While these people may be excellent at what they do; they have no understanding of what goes on inside a bank or finance company. Even a line employee of the institution (particularly a large institution) usually does not have the well-rounded experience of the overall enterprise or the administrative background to see and comprehend the big picture. An expert who does not have diverse administrative background may know how things are done because of habit, e.g. “someone told me to do it that way” or “we’ve always done it that way.” As a result, these people will not be convincing to a judge and jury; especially after a rigorous cross-examination. A convincing consultant or expert must be able to explain the logic or rationale of what was or was not done in easily understandable language.

Also, I understand that attorneys must ask certain questions of a potential expert for the obvious reasons; but the interpretation of the answers may be flawed. My favorite is “How many times have you testified at trial?” While I have handled my fair share of cases, very few have gone to trial and all have settled in my client’s favor; usually after submitting a report. My point here is that picking the right expert, not necessarily the one who has gone to court the most, can really help your case. Perhaps better questions to ask are “How many expert reports have you written?” and “How many of those cases resulted in a favorable settlement?” No expert can turn a case without merit into a winner; but the right expert can highlight the strong parts of your case with enough credibility to induce a favorable settlement.

### Waiting Too Long To Hire An Expert

There are three ways that waiting too long to hire an expert hurts your cause. Probably the most unpleasant of these reminds me of the promo line for a local radio legal talk show — “this is where you call me on the telephone and I tell you that you have absolutely no case!” Seriously though, getting an early read on a case from a consultant/expert can save you a lot of aggravation and money.

Perhaps more important is the second reason which is the expert can *help you considerably to frame the issues*. A good expert has the industry experience to immediately spot where standards and practices have been violated and can explain why these departures are important for your case. They have also seen and participated in numerous similar

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cases so they can translate between breaches and causes of action. You may lose this very valuable assistance if an expert is not retained before a complaint is filed.

One of my favorites is being retained after the discovery period is closed. A good expert can tell you exactly where to look in the files to support your position. What may not seem important or relevant or simply not thought of can be very revealing for your case. Conversely, there are many document requests that may be informative; but, as a practical matter, will never be obtained. As an example in my individual area, regulatory examinations, though very revealing, will never be released.

### Not Taking Your Expert To Depositions and Trial

To someone who knows the industry and its related hedge words, not taking your expert to depositions (or trial) can be really damaging. Very often, the subject of the examination will say something that, to the uninitiated, may sound logical and reasonable; but, the answer may have been carefully phrased and/or contain industry jargon that narrows or limits the response. An expert who is intimately familiar with the language of the trade can suggest questions to expose limiting language. Having your expert appear at trial only for their own testimony deprives you of your expert's opportunity to hear and dissect opposing testimony and perhaps suggest questions to be put to the other side. The result of this ability to probe carefully hedged answers can completely change the impressions intended to be left by the opposing side and, if a trial follows, reverse the impressions intended to be left by the opposition on a judge and jury.

### Limiting The Information Given To Your Expert

Occasionally, an attorney will not give his expert all the information he has. Sometimes the attorney will discuss this information with their expert and both agree that it really would not add any value for the expert to review the information. If that is the case, then "no harm...no foul." If that isn't the case, you could be headed for disaster. If a document contains information unfavorable to your position and you don't show it to your expert; it's a safe bet that the other side will. Picture the scene where opposing counsel asks your expert, "*Mr. ...., now that you've read this document; does that change your opinion?*" The major reason expert witness testimony is invaluable can be summed up in one word, credibility. If the expert loses credibility with a judge and/or jury; the result can be worse than if you had no expert at all. I was taught, early in my career, to never defend an untenable position.

### Allow Sufficient Time

Give the expert enough advance notice that you will need his or her services. A well-reasoned, logical opinion needs to take into account a multitude of factors; some of which may not immediately come to mind. In many of the cases I have worked on, I was surprised that simply reflecting back on the facts caused me to remember additional facets which added to or solidified my opinion. In one recent case, the attorney I was working with was surprised to learn about certain industry customs that I had previously considered so mundane as to not be worthy of mentioning. This is sort of a bonus for plenty of advance warning and frequent communication.

If a report is required, I always like to read it over at least a few times to make sure the thoughts conveyed present all the pertinent facts in an "easy to read and understand" fashion. My past experience has been that a well-reasoned and well-organized opinion or report promotes settlement. A hurried expert analysis is usually flawed; allowing an opposing attorney to have a field day questioning a "rush job."

The attorney-expert team is critical to the successful litigation of complex cases. Experts must be objective; the expert's job is to vigorously search for facts and the truth. Selecting the right expert for your needs is no easy task, but diligent work with experienced trial counsel in the selection and preparation process pays invaluable dividends.<sup>b</sup>

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<sup>1,2</sup> "My Kingdom for an Expert", By Michael B. Lee, Beime, Maynard & Parsons L.L.P.

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*No matter how experienced you are as a lender or how much of your customer's best interests motivated your actions; when a banking relationship runs into trouble the next two words you could easily hear are lender liability.*

### Good Banker or Lender Liability- A Banking Conundrum?

I was prompted to write this article because of the reflections I had on my own training and career in banking contrasted with my experience as an expert witness in finance related cases. I was also thrilled to legitimately sneak in the word conundrum as the new buzz word in economic circles. Years from now, people will be able to date this article for using that word much like the buzz word of several years ago - gravitas. Nevertheless, I am concerned about the conundrum that exists between my training as a lender and my recent experience testifying as an expert witness in financial litigation.

I spent more than 30 years as a lender in commercial banks including over 20 years as a senior policy-making officer and turnaround specialist for troubled banks. In all the training I received and in the experiences I had, good judgment was a most valued ability. I have always worked in a decentralized lending environment where authority, analysis, judgment and responsibility were left to line lenders. After a long period of supervision and assessment of your skills, you were given authority to evaluate lending circumstances and make the decision on every type of loan situation; aggressive new loans, borderline customers and workouts. In fact, the loan administrations in which I worked insisted that the originating officer handle the workout if that circumstance should arise, in order to "learn from your mistakes."

A bank, like any of its customers, is organized to make a profit. It, therefore, requires sales which are usually generated, in large part, by the very same officers responsible for granting loans. Banking is the only industry where the Salesman and the Credit Manager are one and the same person. One of my old bosses told me that being a loan officer was like "a barrel tapped at both ends." The tap on one end is that you must provide intelligent loan decisions to establish and maintain the bank's loan relationships while the tap at the other end represents your duty to protect the bank's capital. Between those two tapped ends lies the conundrum.

There isn't a business in the world that hasn't run into difficulties at some point in its history. Sometimes difficulties arise from good things happening such as when sales growth outstrips working capital or problems can occur from not so good things like an unexpected supply shortage, rise or fall in market prices, etc. Sometimes the difficulties are just a "bump in the road" and sometimes they aren't. It's at these times that even the most experienced loan officer gets to really earn their pay; "Do I make the next advance or not?". Interestingly enough, whether you decide to support your customer or "pull the plug," you need to keep in mind two words - Lender Liability. Regardless of which way you decide to go, if things don't work out well, you may be hearing them all too soon.

As I said at the outset, what prompted me to write this article was the apparent conflict between my training (and I think I had great training) and the rising volume and sophistication of lender liability claims. Judging by the inquiries I get and recent cases I have been involved with, lender liability claims are skyrocketing in number and size.

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Banks, bank counsel and other interested parties have tried mightily to limit this expansion. Many states have passed laws to limit lender liability claims. Loan documents frequently contain mandatory arbitration clauses and a waiver of jury trial and courts have tried to narrow lender/borrower disputes to within the “four corners” of the loan documentation. All to no avail. In the “old days” a borrower might say “you should have never lent me that much money because you knew I couldn’t handle it.” Now the claims involve Fraud, RICO, at least five kinds of negligence along with the milder old favorites of Breach of Contract and the Covenant of Good Faith and Fair Dealing. Having watched the process frequently and at very close range over the past few years yet firmly believing in the tremendous economic benefits for all concerned of a well-trained, intelligent loan officer; what is a banker to do? (Conundrum - A paradoxical, insoluble, or difficult problem; a dilemma)

There are three things to do:

Hopefully, you have been doing this all along; but certainly when a borrower hits that first bump in the road and you are called upon to make difficult decisions; DOCUMENT, DOCUMENT, DOCUMENT. Assuming there are no blatant facts to undermine your actions to this point, the first place an experienced opposing counsel will look is to the bank’s policies and procedures searching for deviations between policy/procedure and actions. There are many other places they will look based upon the individual circumstances which are precluded here by space limitations. The key ingredient is that it’s okay to deviate from policy so long as you follow proper procedures and DOCUMENT the valid business reasons for your actions.

Second, I strongly suggest you read an article entitled “THE TEN COMMANDMENTS FOR AVOIDING LENDER LIABILITY” By Helen Davis Chaitman. Paraphrasing Commandment Number 1 (and I don’t believe it is a coincidence that this is the first commandment); “Thou Shall Take No Precipitous Action”. I have seen an awful lot of situations where the bank could have eliminated litigation, perhaps resurrected the relationship and saved tremendous amounts of money by only living up to this commandment. By following the other 9 commandments as well, you stand a good chance of avoiding further, very substantial liability and litigation.

Thirdly, should you find yourself in a potential lender liability situation, call us (a shameless self-promotion). Seriously, an experienced, credible and totally independent third party to vouch for the bank’s faithfulness to industry standards and practices can make the difference between recovery and loss.

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