

Recent Developments in the Law of Lender Liability
&
Practical Tips for Avoiding Lender Liability Claims

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Recent Developments in the Law of Lender Liability & Practical Tips for Avoiding Lender Liability Claims

A. A Brief History of Lender Liability

1. The Halcyon Days of Lender Liability.

- a. *Kruse v. Bank of America* (1988) 202 Cal.App.3d 38 (Describing \$46 million jury verdict against Bank of America).
- b. *Conlan v. Wells Fargo Bank*, Monterey County Superior Court number 82852 (1988 Judgment of \$10 million in compensatory damages and \$50 million in punitive damages, settled for \$10 million in 1989).
- c. *Penthouse International v. Dominion Federal Savings & Loan Ass'n* (S.D.N.Y. 1987) 665 F.Supp.301, *revs'd*, (2d Cir. 1988) 855 F.2d 963 (\$128 million judgment reversed on appeal).
- d. *Landes Construction Co. v. Royal Bank of Canada* (9th Cir. 1987) 833 F.2d 1365.

2. The Lender Liability Tide Turns.

- a. *Kruse v. Bank of America* (1988) 202 Cal.App.3d 38 (Reversing \$46 million jury verdict against Bank of America).
- b. The Parol Evidence cases: *Alling v. Universal Manufacturing Corp.* (1992) 5 Cal.App.4th 1412, 1433; *Winet v. Price* (1992) 4 Cal.App.4th 1159; *Alex Robertson Co. v. Imperial Casualty and Indemnity Co.* (1992) 8 Cal.App.4th 338; *West v. Henderson* (1991) 227 Cal.App.3d 1578; *FPI Development, Inc. v. Nakashima* (1991) 231 Cal.App.3d 367; *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465; *Banco Do Brasil, S.A. v. Latian, Inc.* (1991) 234 Cal.App.3d 973.

- c. *Banco Do Brasil, S.A. v. Latian, Inc.* (1991) 234 Cal.App.3d 973, 993:

“It is the essence of the judicial function to contribute to legal certainty and reasonable predictability in the affairs of our citizens rather than to suggest that such goals are not attainable. Parties to a business or commercial transactions, such as those to this case, should be able to clearly express their intent as to the nature and scope of their legal relationship and then to be able to rely on that expression The courts simply cannot permit clear and unambiguous integrated agreements such as the one before us, to be rendered meaningless by the oral revisionist claims of a party who, at the end of the game, does not care for the result.”

- d. The enactment of the statute of frauds provision relating to oral promises to lend: Civil Code section 1624(a)(7), formerly 1624(g).
- e. The more troubling cases have been discredited, reversed or limited by subsequent case law.
- 1) Can the implied covenant be the basis for tort liability? *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.* (1984) 36 Cal.3d 752. Compare *Freeman & Mills, Inc. v. Belcher Oil Co.* (1995) 11 Cal.4th 85 and *Della Penna v. Toyota Motor Sales, U.S.A., Inc.* (1995) 11 Cal.4th 37.
 - 2) Do banks owe a fiduciary duty to their customers? *Commercial Cotton Co. v. United California Bank* (1985) 163 Cal.App.3d 511 and *Barrett v. Bank of America* (1986) 183 Cal.App.3d 1362. Compare *Copesky v. Superior Court* (1991) 229 Cal.App.3d 678 [280 Cal.Rptr. 338] (overruling *Commercial Cotton*); *Careau & Co. v. Security Pacific Business Credit, Inc.* (1990) 222 Cal.App.3d 1371; *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465.

- 3) Do banks owe a duty of care to non-customers? *Sun 'n Sand, Inc. v. United California Bank* (1978) 21 Cal.3d 671. Compare *Chazen v. Centennial Bank* (1998) 61 Cal.App.4th 532; *Karen Kane, Inc. v. Bank of America* (1998) 67 Cal.App.4th 1192; *Software Design & Application, Ltd. v. Hoefer & Arnett, Inc.* (1996) 49 Cal.App.4th 472, 479 ("[A]bsent extraordinary and specific facts, a bank does not owe a duty of care to a noncustomer.")

B. Current Theories and Recent Trends

1. Breach of Contract

- a. Breach of an oral agreement to lend or forbear.

Ladas v. California State Auto. Ass'n. (1993) 19 Cal.App.4th 761; *Scott v. Pacific Gas & Electric* (1995) 11 Cal.4th 454, 466-67; *Robinson & Wilson, Inc. v. Stone* (1973) 35 Cal.App.3d 396, 407; *Peterson Development Co. v. Torrey Pines Bank* (1991) 233 Cal.App.3d 103; *Weddington Productions, Inc. v. Flick* (1998) 60 Cal.App.4th 793; *Barton v. Elexys International, Inc.* (1998) 62 Cal.App.4th 1182.

- b. Breach of a part written and part oral agreement.

See *Peterson Development Co. v. Torrey Pines Bank* (1991) 233 Cal.App.3d 103, 115; *Rainshine Resources, Inc. v. International City Bank* (2002) 2002 WL 596724 (unpublished) (Commitment letters).

2. Breach of the Implied Covenant of Good Faith and Fair Dealing.

a. Contractual breach of the implied covenant.

See Comm.Code section 1203; *Carma Developers (Cal.), Inc. v. Marathon Development California, Inc.* (1992) 2 Cal.4th 342, 372.; *Foley v. Interactive Data Systems Corp.* (1988) 47 Cal 3d. 654; *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28; *R.J. Kuhl Corp. v. Sullivan* (1993) 13 Cal.App.4th 1589,1602; *Storek & Storek, Inc. v. Citicorp Real Estate, Inc.* (2002) 100 Cal.App.4th 44; *Pasadena Live v. City of Pasadena* (2004) 114 Cal.App.4th 1089, 1093.

b. Tortious breach of the implied covenant.

See *Commercial Cotton Co. v. United California Bank* (1985) 163 Cal.App.3d 511 and *Barrett v. Bank of America* (1986) 183 Cal.App.3d 1362, overruled by *Copesky v. Superior Court* (1991) 229 Cal.App.3d 678; *Careau & Co. v. Security Pacific Business Credit, Inc.* (1990) 222 Cal.App.3d 1371; *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465. See also *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28; *Freeman & Mills, Inc. v. Belcher Oil Co.* (1995) 11 Cal.4th 85; *Hunter v. Up-Right, Inc.* (1993) 6 Cal.4th1174.

3. Fraud.

4. Negligence. See Civil Code section

Allegations of negligent lending / loan administration often fall into three general categories:

a. Negligent lending (“You lent too much”). See *In re Peeples*, Bankruptcy Case no. 1-86-01685.

b. Negligent failure to lend (“You did not lend enough”).

- c. Negligent failure to oversee construction, business or commercial project for the benefit of the borrower or guarantor.
5. Intentional Infliction of Emotional Distress. See *Janossy v. Washington Mutual Bank* (2002) __ Cal.App.4th __ [2002 WL 31031636 (Not published).
 6. Breach of Fiduciary Duty. See *Copesky v. Superior Court* (1991) 229 Cal.App.3d 678; *Careau & Co. v. Security Pacific Business Credit, Inc.* (1990) 222 Cal.App.3d 1371; *Price v. Wells Fargo Bank* (1989) 213 Cal.App.3d 465, holding that in the absence of extraordinary circumstances, a bank does not owe a fiduciary duty to its customer.
 7. Unconscionability / Duress.
 - a. Statutory authority for unconscionability: Civil Code section 1670.5. See also Civil Code section 1671 (enforceability of penalty and liquidated damages provisions).
 - b. Decisional authority for duress: *Krantz v. BT Visual Images* (2001) 89 Cal.App.4th 164; *CrossTalk Productions, Inc. v. Jacobson* (1998) 65 Cal.App.4th 631, 644.
 - c. Important cases.
 - 1) *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83.
 - 2) *Little v. Auto Stiegler, Inc.* (2003) 29 Cal.4th 1064.
 - 3) *Stirlen v. Supercuts, Inc.* (1997) 51 Cal.App.4th 1519.
 - 4) *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807.
 - 5) *Ridgley v. Topa Thrift & Loan Assn.* (1998) 17 Cal.4th 970.
 - 6) *Harbor Island Holdings v. Kim* (2003) 107 Cal.App.4th 790.

- d. Recent cases.
 - 1) *Greenbriar Homes Community v. Superior Court* (2004) 117 Cal.App.4th 337.
 - 2) *Jaramillo v. JH Real Estate Partners, Inc.* (2003) 111 Cal.App.4th 394.
 - 3) *Fitz v. NCR Corp.* (2004) 118 Cal.App.4th 702.
- 8. Libel, Slander, Defamation.
- 9. Bankruptcy Code Claims.
 - a. Preference Claims (Bankruptcy Code section 547).
 - b. Fraudulent Transfer Claims (Bankruptcy Code section 548).
 - c. Equitable Subordination claims. See Bankruptcy Code section 510(c); *Feder v. Lazar* (In re Lazar) (9th Cir. 1996) 83 F.3d 306, 309.
- 10. Assignment for the Benefit of Creditors Claims.
 - a. Statutory Framework: Code of Civil Procedure sections 493.010 - 493.060, 1204 - 1204.5 and 1800 - 1802; Civil Code section 1954.1.
 - b. *Sherwood Partners, Inc. v. Lycos, Inc.*, ___ F.3d ___ [05 CDOS 343] (9th Cir. January 12, 2005).
- 11. Breach of other statutes.
 - a. Business and Professions Code section 17200.
 - b. The Fair Labor Standards Act.
 - c. The WARN Act. *Pearson v. Component Technologies Corp.* (3d Cir. 2001).

- d. Environmental Statutes, specifically the Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”) and the Resource Conservation and Recovery Act (“RCRA”). See *United States v. Fleet Factors Corp.* (11th Cir. 1990) 901 F.2d 1550, 1558. See also the secured creditor exemption set forth in the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996.
 - e. Usury Statutes. See *Jones v. Wells Fargo Bank* (2003) 112 Cal.App.4th 1527.
 - f. Anti-deficiency Statutes. See Code of Civil Procedure sections 580b - 580d and 726 and Civil Code sections 2924c. See *Prestige Limited Partnership - Concord v. East Bay Car Wash Partners (In re Prestige Limited partnership - Concord)* (Bk.N.D.Cal. 1997) 205 Bankr. 427; *Shin v. Superior Court* (1994) 26 Cal.App.4th 542.
 - g. Local Predatory Lending and Elder Abuse Statutes. See *Black v. Financial Freedom Senior Funding Corp.*(2001) 92 Cal.App.4th 917 (Elder abuse claims); *American Financial Services Association v. City of Oakland* (2003) 111 Cal.App.4th 1435, review granted (2004) 4 Cal.Rptr.3d 745. See L.A. Mun.Code section 162.07.B; Oakland Mun.Ord. section 5.33.070 (stayed pending appeal).
12. Aiding and Abetting / Conspiracy. See *Software Design & Application, Ltd. v. Hoefer & Arnett, Inc.* (1996) 49 Cal.App.4th 472; *Chazen v. Centennial Bank* (1998) 61 Cal.App.4th 532 (aiding and abetting). *Weinbaum v. Goldfarb, Whitman & Cohen* (1996) 46 Cal.App.4th 1310 (conspiracy).
 13. Anti-Tying Claims.
 14. Foreclosure / bid-rigging claims, involving both real and personal property foreclosures.
 15. Check and Deposit-related Claims.

C. Who are Potential Claimants?

1. Borrowers or depositors.
2. Investors, vendors, suppliers and lenders of the borrower / depositor. See *Chang v. Redding Bank of Commerce* (1994) 29 Cal.App.4th 673.
3. Prospective borrowers.
4. The government.

D. Important Defenses Available to the Lender.

1. The Parol Evidence Rule.
 - a. Statutory authority.
 - 1) Code of Civil Procedure section 1856.
 - 2) Civil Code section 1625.
 - 3) Commercial Code section 2202.
 - 4) See also Civil Code sections 1635 - 56; Code of Civil Procedure sections 1859 - 66.
 - b. Important cases.
 - 1) *Bank of America National Trust and Savings Ass'n. v. Pendergrass* (1935) 4 Cal.2d 258.
 - 2) *Pacific Gas & Electric Co. v. G. W. Thomas Drayage & Rigging Co., Inc.* (1968) 69 Cal.2d 33.
 - 3) *Tenzer v. Superscope, Inc.* (1985) 39 Cal.3d 18.
 - 4) *Alling v. Universal Manufacturing Corp.* (1992) 5 Cal.App.4th 1412.

- 5) *Banco Do Brasil, S. A. v. Latian, Inc.* (1991) 234 Cal.App.3d 973, 1011
- 6) But see *Pacific State Bank v. Greene* (2003) 110 Cal.App.4th 375.

2. The Statute of Frauds.

a. Statutory authority.

- 1) Civil Code section 1624.
- 2) Civil Code section 1091.
- 3) Code of Civil Procedure sections 1971, 1974.
- 4) Commercial Code section 1206.

b. Important cases.

- 1) *Franklin v. Hansen* (1963) 59 Cal.2d 570.
- 2) *Weddington Productions, Inc. v. Flick* (1998) 60 Cal.App.4th 793.

3. Loan documentation provisions which provide defenses or which provide disincentives for bringing claims.

a. The integration clause.

b. The no-oral-modification clause.

c. The no-reliance / independent investigation clause.

d. The no-duty to-inspect-or-supervise clause. See *Zlatanov v. Bank One, N.A.* (January 7, 2005) ____ Cal.App.4th ____ [2005 WL 32952].

e. The attorneys' fees clause.

- f. The jury trial waiver or judicial reference / ADR provision. But see *Grafton Partners LP v. Superior Court* (Feb. 6, 2004) 115 Cal.App.4th 700 [04 C.D.O.S. 1167] (holding that jury trial waivers are unenforceable); *review granted and opinion superseded by* 12 Cal.Rptr.3d 287 [04 C.D.O.S. 3491]. See also *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83; *Ting v. AT&T* (9th Cir.2003) 319 F.3d 1126; *Cruz v. PacifCare Health Systems, Inc.* (2003) 30 Cal.4th 303 (addressing factors to consider when evaluating whether arbitration clauses are enforceable).
4. Res Judicata.
 - a. A properly conducted foreclosure sale results in a final adjudication of the rights of a borrower and lender. 6 *Angels, Inc. v. Stuart-Wright Mortgage, Inc.* (2001) 85 Cal.App.4th 1279, 1283.
 - b. The filing and allowance of a proof of claim (and a debtor's failure to object to the claim) bars all counterclaims which could have been brought in connection with that claim. *Siegel v. The Federal Home Loan Mortgage Corp.* (9th Cir. 1998) __ F.3d __ [1998 U.S.App.LEXIS 8782].
 5. Judicial Estoppel. *Billmeyer v. Plaza Bank of Commerce* (1995) 42 Cal.App.4th 1086; *Conrad v. Bank of America* (1996) 45 Cal.App.4th 133.
 6. Preemption. See *Washington Mutual Bank v. Superior Court* (2002) 95 Cal.App.4th 606.
 7. Privilege. See *Brown v. Kennard* (2001) 94 Cal.App.4th 40; *Navellier v. Sletten* (2003) 106 Cal.App.4th 763 (Civil Code section 47) and *Kruse v. Bank of America* (1988) 202 Cal.App.3d 38 (Bank is privileged to pursue its own economic interests).

E. Strategies for Avoiding or Minimizing Lender Liability Claims.

1. Know your borrower. Obtain and review financial statements utilizing the Bank's form financial statement, and conduct an independent investigation of the borrower's background.
2. Utilize a good commitment letter and proper pre-loan origination documentation.

Sample language for commitment or expression of interest letter:
"The terms set forth in this letter are for discussion purposes only and do not constitute an offer or commitment of any kind by the Bank to make a loan or extend credit. Any agreement to make a loan must be approved by the Bank's credit or loan committee and must be memorialized in a formal loan agreement or promissory note signed by all parties to be valid and enforceable."

3. Utilize good loan documentation.
 - a. The importance of a good integration clause.

Example: "This Agreement contains the entire agreement between the parties with respect to the subject matter hereof and supersedes all prior negotiations and communications, oral and written."

- b. The importance of a good attorneys' fees clause. See *Aozora Bank, Ltd. v. 1333 North California Boulevard* (2004) 119 Cal.App.4th 1291 (Bank precluded from recovering attorneys' fees due to the narrow scope of attorneys' fees clause).
 - c. The importance of a good no-oral-modification clause.

Example: "This Agreement may not be amended or modified in any respect whatsoever except by an instrument in writing signed by all of the parties to this Agreement."

- d. The importance of a good jury trial waiver and ADR provisions.
- e. The importance of a good no-waiver clause.

Example: “No exercise by the Bank of one right or remedy shall be deemed an election, and no waiver by the Bank of any Event of Default shall be deemed a continuing waiver. No delay by the Bank shall constitute a waiver, election, or acquiescence by it. The Bank shall have the right to take any action it deems necessary against any party in order to enforce or perfect, or to realize on its security interest in the Collateral.”

- f. The importance of knowing your old forms and their relationship to recent developments in the law.
Example: Security Agreements, UCC-1's and Commercial Code Sections 9502, 9509 - 10.
- g. The value of using factual recitals in specially prepared loan or workout agreements. See Evidence Code section 622 (“[F]acts recited in a written instrument are conclusively presumed to be true”); *Plaza Freeway Limited Partnership v. First Mountain Bank* (2000) 81 Cal.App.4th 616; *Miner v. Tustin Avenue Investors* (2004) 116 Cal.App.4th 264.
- h. The value of using specialized loan provisions which clarify the parties’ relationship and agreement, such as, for instance, a release clause, a “no-reliance” clause, an “as-is / no warranty” clause or a “no duty to inspect or supervise” clause.

Example of no-reliance clause: “Each party acknowledges to the other party that it has had the opportunity of being represented by independent legal counsel of its own choice throughout all of the negotiations which preceded the execution of this Agreement and that it has had the opportunity to obtain the advice of such independent legal

counsel. Each party further acknowledges that it has had adequate opportunity to make whatever investigation or inquiry they may deem necessary or desirable in connection with the subject matter of this Agreement prior to the execution hereof and the delivery and acceptance of the consideration specified herein. Each party further acknowledges that it has not relied on anything said or not said by the other party in entering into this Agreement and that it is executing this Agreement solely based on its own independent analysis and investigation.”

- i. The importance of a proper loan structuring and collateralization. See *Cadle Co. II v. Harvey* (2000) 83 Cal.App.4th 927 (addressing the “sham guaranty” issue) and *River Bank America v. Diller* (1995) 38 Cal.App.4th 1400 (same).
5. Monitor your loan and your collateral. Example: the effect of an undetected bankruptcy on a perfected security interest in cash collateral (Bankruptcy Code section 552).
6. Be careful in the use and documentation of more controversial products, such as reverse mortgages, shared appreciation loans and equity sharing arrangements. See *Connor v. Great Western Savings and Loan Ass’n.* (1968) 69 Cal.2d 850.
7. Be careful in the preparation of loan write-ups and internal communications, particularly e-mail, and particularly after a dispute has arisen.
8. When in doubt, ask.

Biography of Peter M. Rehon

Mr. Rehon is a shareholder in the law firm of Rehon & Roberts, a Professional Corporation, in San Jose, California. His main areas of practice include banking and financial institutions law, commercial litigation, appellate practice, real estate law and bankruptcy.

Mr. Rehon received his B.A. degree from the University of California at Santa Cruz in 1977 and his J.D. degree from Hastings College of Law, University of California, in 1981. He has written three action guides for the California Continuing Education of the Bar (CEB) entitled *Obtaining a Writ of Attachment* (CEB 5th ed. Fall 2000), *Obtaining a Writ of Possession* (CEB 3d ed. Fall 2004), and *Obtaining an Injunction* (CEB 3d ed. Fall 2000) and a law review article entitled "The Law of Equitable Subordination" for *The Banking Law Journal* (1991). Mr. Rehon was also a consultant for CEB's action guide entitled *Obtaining the Appointment of a Receiver* (CEB Winter 1993). Mr. Rehon has been an instructor for the University of California Extension Program and a panelist in programs put on by the California Bankers Association, the Santa Clara County Bar Association, the National Business Institute and various private organizations.

Mr. Rehon is a member of the State Bar of California and the Santa Clara County Bar Association. Mr. Rehon was admitted to practice in California in 1981, and is admitted to practice in the U.S. District Court for the Northern District of California (1981), the U.S. District Court for the Eastern District of California (1982), the Ninth U.S. Circuit Court of Appeals (1982), the U.S. District Court for the Southern District of California (1987), and the U.S. District Court for the Central District of California (1988).

Mr. Rehon has been attorney of record in the following cases resulting in published opinions:

Billmeyer v. Plaza Bank of Commerce (1995) 42 Cal.App.4th 1086 [50 Cal.Rptr.2d 119, 96 CDOS 1187] [ordered published by Cal. Sup. Ct., Feb. 15, 1996 (See *Conrad v. Bank of America* (1996) 45 Cal.App.4th 133, 151 n.9)] (representing defendants and respondents Plaza Bank of Commerce and Pamela G. Bogle).

Title Insurance Company of Minnesota v. Comerica Bank-California (1994) 27 Cal.App. 4th 800 [32 Cal.Rptr.2d 735] (representing defendant and respondent Comerica Bank-California).

Bily v. Arthur Young & Company (1992) 3 Cal.4th 370 [11 Cal.Rptr.2d 51] (representing amici curiae American Bankers Association and California Bankers Association).

Great American First Savings Bank v. Bayside Developers (1991) 232 Cal.App.3d 1546 [284 Cal.Rptr. 194], ordered decertified (March 12, 1992) __Cal.3d__ (representing party seeking decertification, California Bankers Association).

Bank of America v. Salinas Nissan, Inc. (1989) 207 Cal.App.3d 260 [254 Cal.Rptr.748] (representing plaintiff and respondent Bank of America).

Transamerica Title Insurance Company v. Superior Court (1987) 188 Cal.App.3d 1047 [233 Cal Rptr. 825] (representing plaintiff and real party in interest Bank of the West).

In re Albert Hakim, 212 Bankr. 632 [1997 Bankr. LEXIS 1449; 97 DJDAR 12834] (Bk. N.D. Cal. 1997) (representing the debtor, Albert Hakim).