

Deals Gone Wrong

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Among other things, professionals will need to understand and monitor the extensive statutory and regulatory web.

The Pitfalls of Private Money Lending

After housing prices in the United States peaked in early 2006, home values started to decline in 2006 and 2007, and they reached new lows in 2012. On December 30, 2008, the Case-Shiller Home Price Index reported its

largest price drop in its history. Increased foreclosure rates in 2006–2007 further fueled the decline in the United States economy. The credit crisis resulting from the bursting of the housing bubble is—according to general consensus—the primary cause of the 2007–2009 recession in the United States. Because of the sharp decline in real estate value, as well as private money loans’ heavy reliance on property value, many borrowers defaulted on loans, leaving investors holding the bag. Today, the struggle for credit continues, and many potential borrowers seek relationships with private lenders for the purposes of securing private money loans or, as they are often called, “hard money” loans.

While banks are traditional sources of financing, when bank financing is unavailable or unfeasible individuals or organizations may offer private money, which involves qualifying guidelines that differ from traditional loan guidelines. In return, private money lenders seek to earn above-

average rates of return on their money, typically well out-pacing the rates on traditional financing. A borrower in a private money transaction may not qualify for a traditional loan or may require capital on a much shorter timeline than available through traditional means. For various reasons engaging in private lending practices comes with a greater risk that a borrower may not repay the private money loan on time, if at all, than engaging in traditional lending practices. Private money loans are thus characterized by a short-term, high interest rate, and a lender relies heavily on the value of collateral property as opposed to the credit worthiness of a borrower.

There will always be a need for money available quickly for risky investments or by borrowers with subpar credit. As discussed below, however, in response to the recession and real estate market decline, legislatures have enacted new rules and regulations that apply to private money loans, and the case law interpreting these



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laws continues to develop. As attorneys structuring or defending these transactions, we must stay apprised of variances in such rules and laws. To that end, this article surveys recent litigation, regulation trends, and themes on private money transactions, as well as discusses common issues the attorneys should know about.

The Standard of Care: Structuring a Quick Deal

In anticipation of litigation involving private money loans, one important question is whether attorneys and other professionals involved in private money loans are held to a different standard of care than those involved in more traditional loans. The answer, of course, is that it depends.

The paperwork involved in a private money loan is not all that different from a traditional loan. While situations vary, the typical loan, both private and traditional, involves a letter of intent, followed by a purchase and sale agreement; a preliminary title report; title insurance; proof of funds; proof of insurance; a mortgage or deed of trust; and sometimes, a guarantee. In addition, loans, and particularly residential loans, may require an appraisal from an outside party, a property inspection report, a geology inspection, and the borrower's financial records.

In general, when an attorney represents any secured lender in preparing this documentation, the relevant standard requires the attorney to use reasonable skill to ensure that the lender can foreclose and reach its collateral after a default. See *Bremer Bus. Fin. Corp. v. Dorsey & Whitney LLP*, 352 B.R. 103, 176 (Bankr. D. Minn. 2006) (attorney breached standard of care by failing to obtain the government approval necessary to validate the parties' security agreement), *reversed on other grounds*, 553 F.3d 609. This standard is not relaxed for private money transactions simply because the deals involve private rather than institutional lenders or because they involve shorter lending periods. Instead, professionals are expected to conduct the same, detailed process in structuring a private money transaction as conventional lenders would. When such unconventional aspects arise, a professional dealing with private money should at least inform the client of the missing pieces and ensure that the cli-

ent wants to continue if the timeline does not permit preparing them. See *Lametta v. Todisco*, 2003 Conn. Super. Lexis 2542, at *24-27, 2003 WL 22205916 (Conn. Super. Ct. Sept. 8, 2003). See also *Boresek v. United States Dep't of Agric.* (June 9, 2015) 2015 U.S. Dist. Lexis 74156. Thus, in some ways, the standard may be even higher because there are more moving parts through which a professional must navigate.

Ultimately, there are unlimited ways to structure a private money deal so that both an investor and borrower can proceed. In turn, however, there are an unlimited number of factors which much be considered by a lending professional, such as the proper rate to charge given the risk or whether to hold an interest reserve account, and if so, for how long. Often an investor will want a personal guarantee attached to a loan. If so, then a professional involved in a private money loans should take care to ensure the guarantee is handled properly. Perhaps to a certain investor the business plan, as opposed to the collateral, is more important. Or maybe there is an opportunity to cross-collateralize property or other assets. Whatever it may be, there is certainly a structure that works in the private lending world. But having knowledge is crucial. A private lending professional should take steps to ensure that his or her client is fully apprised of the process at every step of the way and is provided with all material information. If not, and if a deal goes bad, it should come as no surprise that an investor will say that the loan never would have been made had he or she "only known about" x or y, regardless of whether that is really the case.

Standard of Care: Due Diligence

Although private money loans typically emphasize the value of collateral over a borrower's credit and ability to repay, professionals involved in private money loans still have an obligation to perform due diligence into more than just the collateral. The due diligence requirements will differ depending on the loan, of course. But, at the very least, due diligence should include either an appraisal from an outside party or some other reliable opinion about the collateral's value; a property inspection report; a geology inspection, depending on the locale of the structure; and a review of a borrower's provided financial records. Additionally, an in-person inspec-

tion of property, if possible, is advisable as part of a loan evaluation. Finally, private money professionals should maintain adequate knowledge of the subject locale's real estate market.

One recent case in the U.S. District Court for the District of Oregon, *Boresek v. United States Dep't of Agriculture*, exemplifies how undertaking due diligence belongs front and center in these deals. 2015 U.S. Dist. Lexis 74156 (D. Or. June 9, 2015). In this case, the private lender, through his investment corporation, issued a loan to a cranberry farmer but ultimately lost the investment due to a lack of due diligence and the discovery of a senior lien that was not paid off in the transaction. *Id.* at *1-3. Of significance, the private lender was unable to enforce its priority lien position through equitable subrogation because it could not prove that its ignorance of the senior lien was the product of excusable neglect. *Id.* at *1-2.

In finding that the lender was negligent in its due diligence, the *Boresek* court determined that a private money lender must perform *greater* due diligence when investigating a potential transaction, including the value and security of the collateral, not less than an institutional lender. *Boresek*, 2015 U.S. Dist. Lexis 74156 at *6-10. The court noted that although it might be commercially reasonable to rely on an accurate title report, the lender in *Boresek* knowingly relied on an inaccurate title report. *Id.* at *10-13. Investigating the known error could have allowed the lender to discover the hidden lien. The court listed factors that it considered in judging the lender's failure to perform the due diligence adequately, including verifying income, reviewing tax returns and financial statements, obtaining appraisal reports or a comparative market analysis, meeting with borrowers, and investigating other loans to the borrowers. The court also took issue with the fact that the lender's agent was not experienced in the borrower's industry. *Id.* at *10-19. The *Boresek* court was not willing to relieve the private money lender from the consequence of its failure to investigate. As can be seen from the rationale of *Boresek*, these nontraditional transactions can require even more attention to due diligence documents than their traditional counterparts, particularly given the fast pace at which they proceed.

Other Standard of Care Issues: Servicing

Another issue that arises in private lending is the standard of care in servicing, modification, and foreclosure. When a borrower's financial circumstances start to move south, there is no FDIC insurance and the lenders cannot simply take the money back. Their ability to collect is often tied solely to a borrower and the ability to foreclose on the collateral. This is not to say that private lenders or investors want to foreclose. Private investors lend money for fees and interest, and thus they want to service a loan for as long as possible. But private money lenders that also service these loans have a fiduciary duty to protect their investors' collateral. Thus, servicers are obligated to act, and act quickly, when the borrowers are in breach of an agreement. The circumstances that trigger a servicer's obligation to act toward modification or foreclosure are not limited to missing interest payments or failing to pay the principal at maturity. Private money loans often include other provisions, such as waste provisions, allowing a servicer to foreclose when a borrower's conduct causes the value of the property to decline; illegal transfers clauses or "due-on-sale" clauses, under which payment becomes due if a borrower attempts to deed the property to another entity; provisions prohibiting unapproved junior liens that may dilute a borrower's ability to repay the senior lien; and call provisions, through which a lender retains the right to review the financial condition of a borrower on an ongoing basis and call a loan due if the borrower's position becomes suspect. Under these or similar provisions, a private money lender can and should act to modify or to foreclose a loan when a borrower has breached its obligations. However, as with any other situations, there will be some judgment calls for a servicer to make on when and how to proceed. If a lender becomes a servicer for investors, it is advisable to list the servicing duties clearly and in detail, as well as the level of discretion provided to the servicer, in a separate document, hopefully to avoid a dispute down the line between the servicer and investors.

Ensuring Compliance with All Regulations

As is to be expected, private money lending is fraught with rules and regulations,

the navigation of which can cause even the most careful attorney a headache. For instance, a lender or mortgage broker may be governed by different regulations—both state and federal—depending on a number of factors, including whether a loan is a consumer loan on a personal residence; whether a loan is on a residential dwelling, and then whether the dwelling is a personal residence, owner occupied, or non-owner occupied; the number of investors involved in a specific loan; how funds for investment are raised; and the volume of business done, either in the aggregate or on a specific loan.

A private money lender—and by extension any lawyer working with private money clients—must be aware of the extensive rules and requirements that apply to their highly regulated industry. However, even that is not enough; a lending professional or a lending attorney must also be aware of the constant updates and changes to the various laws. For instance, in California, one such law passed in 2012 regarding investor suitability requirements and took effect January 1, 2013. Cal. Bus. & Prof. Code §10232.45 (setting further requirements to determine investor suitability following the crash of the real estate market). This law added a whole new level of requirements to the already heavily regulated profession, requiring, among other things, a broker to determine whether an investor can invest in a certain loan or indeed in any loans at all. A professional unaware of all of the new and constantly changing requirements will set him or herself up for a professional liability claim down the line.

Setting Interest Rates in Light of Usury Laws

As a result of being primarily collateral backed, one of the defining characteristic of private money lending is high interest rates. Thus, when deals go south, it is not uncommon for a borrower to raise usury claims against a private money lender.

More than half of the states have usury laws in place, which vary significantly. Many states, such as California, place a cap on loan rates generally, subject to certain exceptions, including who made the loan or the collateral used as security. *See* Cal. Const. Art. 15. In Arizona, the "[i]nterest on any loan, indebtedness or other obliga-

tion shall be at the rate of ten per cent per annum, *unless a different rate is contracted for in writing,*" effectively eliminating the cap. Rev. Ariz. Stat. §44-1201. Similarly, in Washington, interest rates on loans made primarily for a commercial, agricultural, investment, or business purpose may exceed rates proscribed in the state's usury law. *See* Wash. Rev. Code §19.52.080.

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Some common penalties for violating usury statutes include invalidation of a borrower's obligation to pay interest, recovery of double or triple the usurious interest paid, nullification of a loan contract, or assessment of fines ranging between three and six figures. Some states, such as Florida, even impose criminal penalties. *See* Fla. Stat. §687.071.

While they may not always apply, a private-money lending professional should always monitor and stay aware of the usury statutes in his or her jurisdiction and stay on their right side. Failing to do so will encourage a lawsuit given the extensive damages potentially available to a plaintiff.

Dual Representations and Conflicts of Interest

One final recurring theme that every attorney involved with private money lending will want to understand is how claims can arise from dual representation or conflicts of interest, whether real or imagined. For instance, conflict of interest problems can arise when one attorney represents both parties to a transaction, or both a party to the transaction and a benefited third party. *See, e.g., In re Disciplinary Proceeding Against Egger*, 98 P.3d 477 (Wash. 2004).

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Third-party beneficiary problems arise when one party or a non-party claims to have been the intended beneficiary of a professional's services in the transaction. For example, in *Freedom Mortg. Corp. v. Burnham Mortg., Inc.*, 720 F.Supp.2d 978 (N.D. Ill. 2010), an attorney hired by a mortgage broker and title insurer as a closing agent was subjected to claims of negligent misrepresentation and negligence by the lender, arising from an alleged fraudulent mortgage flipping scheme. In allowing the lender's claims to proceed, the *Freedom Mortg. Corp.* court reasoned that the attorney's work was not adversarial in relation to the lender in that all parties typically rely on the closing agent's services. See also *In re O'Brien*, 423 B.R. 477 (Bankr. D. N.J. 2010) (applying New Jersey law) (finding the lender's attorney jointly liable for damages incurred by the borrowers because the lender could not have perpetrated his fraudulent scheme without the attorney's complicity and the attorney knew, or should have known, that the lender's scheme was wrong).

A real estate broker handling private money should take care to determine the identity of the client. In some cases, a broker will represent only the investors, and there will be another broker representing the borrower. However, often a broker will also represent a borrower, first taking a commission from making the loan, and then later from the investors, and that same broker may also service the loan after that. In such a case, a broker may, depending on the circumstances, owe fiduciary duties to both the borrower and the investors, similar to a dual agency relationship in a traditional sales transaction. Finally, a potential conflict may come up when a lending professional has his or her own money at stake. If a fiduciary duty is owed to investors, then a self-dealing argument can potentially be raised. In this scenario, to prevent potential claims to the greatest extent possible, a lending professional should carefully document all correspondence so that all loan participants are aware of the different existing relationships and investments.

Conclusion

In the Wild West of private money lending, which involves more risk for lenders

or investors and more creative solutions in structuring deals, it is to be expected that lawsuits will follow. A mindful lending professional should carefully analyze each individual transaction, particularly when he or she completes the due diligence, and err on the side of expanding investigation and disclosure to his or her clients. Additionally, servicing an existing loan, including choosing and advising when to foreclose and to modify, can be just as riddled with pitfalls as the initial funding processes. Finally, as explained above, due to the tangled web of regulations and legal requirements, including vastly different usury laws throughout the country, paying attention to detail and strictly adhering to those rules are imperative. While no amount of caution can entirely prevent subsequent lawsuits, it can go a long way toward minimizing the risk, and just as importantly, it could significantly affect the outcome of a case should a plaintiff file one. 