2002

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Recommended Citation

Bernhardt, Roger, "(WHEN) AM IMY BORROWER'S KEEPER? GOOD FAITH AND LOAN WORKOUTS" (2002). *Publications*. Paper 241.

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(WHEN) AM I MY BORROWER'S KEEPER? GOOD FAITH AND LOAN WORKOUTS

The *Storek* Case: Predatory Lending Redux

Roger Bernhardt

It happens all the time: A line-of-credit lender cuts off its customer's credit just when she needs it the most, or—as in *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (2002) 100 CA4th 44, 122 CR2d 267—a construction lender stops making the scheduled advances precisely when the project is almost ready to fly. Borrowers in such cases have long argued for liability on the ground that their lenders were their fiduciaries, but that claim has never gotten very far. In this decision, the borrowers made an even more serious accusation—that the lender had never really intended to fully fund the project, but merely kept it afloat long enough to enable its own affiliate to foreclose on a related loan and thereby pick up the property on the cheap. According to the borrowers, the loan contract hedged in the construction draws so tightly that default was inevitable, and, indeed, intended.

The jury in *Storek* agreed with the borrower's version of the facts. Sometimes predatory lenders do make loans, not to earn interest, but rather to acquire the debtor's collateral for the price of the loan; foreclosure and forfeiture of the security being more profitable to them than even usurious interest. But here the dirty tricks arose, according to the borrowers, not when the loan was first made, but when it was later worked out. Is that predatory lending, too?

Once a loan gets into trouble, the lender's attitude often changes; but even when a deal is heading south, a lender may agree to pump more rather than less money into the project. The loan officer may describe this benevolence to the borrower as altruism and confidence, but the underlying fact is that the loan committee has decided that it is in the lender's best interest: A completed project will more likely be able to pay itself off, or—if it is still underwater after completion—the pickings may be more attractive at that later stage than they are when the project is still only a hole in the ground. And that last consideration can be true even when the lender has already written off the project as an ultimate loser: It still may be more advantageous to advance enough additional funds to enable the borrower to finish the project first before taking it over and pushing him out. After all, if the borrower still sees a mirage of hope (for example, that the market will completely turn around tomorrow), why not indulge him for now, especially if it makes the bank better off later?

Predatory Lending: Good Faith or Reasonableness Standard?

Is it a predatory practice for a lender to keep a troubled loan alive in order to make the ultimate foreclosure easier or more profitable—*i.e.*, does such conduct violate the implied covenant of good faith and fair dealing, which the courts are so often prone to find in such situations? Not necessarily, according to the *Storek* decision, because sometimes a duty of good faith is simply not involved. Citicorp (the lender) may have been as bad as Storek (the borrowers) alleged, but everything it did was authorized by the terms of its loan contract. Only if there was a duty of good faith over and above the duty to comply with the terms of the loan contract would Citicorp's dirty intentions (keeping alive a loan it didn't believe in) be actionable. Storek might have had to prove that Citicorp acted in bad faith, but, more importantly, it had to prove that Citicorp had a *duty* to act in good faith. Surprisingly, it could not do so.

The duty to act in good faith does not require a party to do anything that the contract expressly says she doesn't have to do, nor does it require her to do something that the contract expressly says she may decline to do. This loan agreement said that Citicorp could elect to stop advancing funds when the budget was out of balance. Although a duty of good faith is sometimes imposed even in the face of contradictory language in the contract, that happens only when necessary in order to keep the contract binding, by making a promise real rather than illusory. This loan agreement had sufficient other consideration to make it enforceable without adding in such a duty. A duty of good faith is also sometimes imposed in order to prevent abuse of a "satisfaction" clause, but that occurs only when aesthetic or personal taste is involved; when the issue is one of commercial value (as here), an objective standard of reasonableness is employed

instead of the subjective standard of good faith. Thus, Citicorp's obligation to continue funding was subject to a reasonableness standard, but not also to a good faith standard.

Sensible or Honorable?

At first blush, reasonableness might sound like a more demanding standard than good faith because it appears to permit the arbiter to second guess the original decision maker. In common interest developments, it is usually the critics of excessive control by homeowner association boards who want judicial review to be objective rather than subjective. In loan law, however, a requirement of good faith is considerably more terrifying than reasonableness. Here, for instance, the project budget was out of balance, and the loan contract said it shouldn't be if advances were to continue; that makes it almost impossible to call the decision to halt funding unreasonable. But when good faith is the standard, even a reasonable decision can be tainted with mala fides.

To many jurors, a good-hearted banker is nothing but an oxymoron

For example, suppose one of the loan review committee members argued to his skeptical colleagues that, even if they believed the project would probably fail, giving the borrowers extra time or extra funds would not hurt, because it would increase the value of the project and would give the borrowers more time to hang themselves, making it easier for the bank to ultimately get rid of them. Does that statement now make the committee's decision to continue funding, or to increase draws, a bad faith action by the bank? Even if the speaker denies having said it, does it matter? A good-hearted banker is an oxymoron to many jurors; and, even for bankers, good faith is not regarded as the best way to get your money back. Thus, the court's rejection of the good faith standard entirely is most significant, like keeping a negligence claim against a rich landlord from getting to the jury.

But is the victory complete? The bank's behavior in taking advantage of favorable provisions in the loan contract may have been reasonable—and may be insulated from review for good faith—but what about the inclusion of those provisions in the contract in the first place? That was where the bad faith arose according to Storek: entering into the loan agreement with no real intention of fully financing the project. But that seems to me to be an even less plausible place to impose good faith on parties.

In the initial negotiation of a contract, the negotiators may be subject to principles of truth and honesty, but I do not think they are also subject to the duty of good faith. *A* is not prohibited from demanding things of *B* on the ground that they would hurt *B*. Some of my friends set ridiculously high prices on houses they want to sell, while others make only sportingly low offers for ones they are interested in buying. Because the other side can always say no, good faith applies more to ongoing performance of a completed contract than to formation of the contract itself. (Or am I confusing unreasonable offers with bad faith offers?)

But the kicker here was that this was not really a new loan between complete strangers. The peculiar structure of the transaction may have made it look that way, but in substance it was more like the workout of a troubled existing loan (a line of credit from Citicorp's parent corporation, Citibank, to the City of Oakland, that was secured by deeds of trust on Storek's property if it ever was drawn down). A differently minded court might have found a way to impose a good faith standard on new demands made during a workout without imposing that standard on demands made in the original loan contract.

Storek asks only whether Citicorp's decision to stop funding was subject to a good faith standard; it does not ask whether a similar standard applied to the lender's demand for the provision in the loan agreement that allowed it to stop funding. Perhaps the court was just fooled by the overly complex structure of the transaction, or perhaps it intentionally didn't want to add yet another variable into the mix. Either way, lenders are probably better off than they were before. They can probably get away with demanding favorable provisions in the original loan documents, and can thereafter invoke those provisions without fear of being accused of bad faith during later workout sessions; only when the workout leads to another, new set of different loan provisions is there any uncertainty about how those will be judged.

Afterthought on Fraud

One inevitably wonders about fraud in a case like this. The jury awarded the plaintiffs \$40.92 million for fraud, in addition to \$900,001 for breach of the covenant of good faith, but the appellate court threw out the fraud verdict in an unpublished part of the decision. Although the original trial court decision in this case was not certified for publication (and was vacated by the appellate decision), it can be found on Westlaw. See *Storek & Storek, Inc. v Citicorp Real Estate, Inc.* (Alameda County Super Ct, Feb. 14, 2002, No. 7320277) 2002 WL 222574. That opinion indicates that the plaintiffs' theory was promissory fraud: a false implied promise by Citicorp to perform in accordance with the implied covenant of good faith. In trying to decide whether an action for promissory fraud lies in this case, the court wondered about what to do "when the promise itself is implied such that the misrepresentation is doubly implied—once from the implied promise and again from the implied intention to perform that promise." (Opinion, p 9.) I think we should all be grateful that this part of the opinion went unpublished, so that we don't have to figure that one out.