Muddy waters: The tort of ‘negligent underwriting’ or ‘improvident lending’ in mortgage lending litigation

By Marc J. Lifset and Jeffrey P. Barringer*

Claims against lenders sounding in negligence for “negligent underwriting” or “improvident lending” are appearing with increased frequency in the pleadings of residential mortgage borrowers. Fueled by the foreclosure crisis, the claims often appear among a barrage of claims, which may include alleged TILA and RESPA violations, as well as state law claims.

In the past, most jurisdictions made clear that such a claim failed because a lending relationship does not impose a legally recognized duty. However, more recent judicial, legislative and regulatory developments have muddied the waters.

Negligence requires existence of a duty – historically absent in lending relationships

Courts long have held that a cause of action founded upon negligence requires a party to demonstrate “the existence of a duty, the breach of which can be considered the proximate cause of the damages suffered by the injured party.” Without a legally recognized duty there can be no liability.

In Whitley v. Taylor Bean & Whitacker Mortgage Corp., 607 F. Supp. 2d 885 (N.D. Ill. 2009), for example, it was alleged that the lender owed the borrower a duty to protect the borrower from the unreasonable risk that the borrower would eventually be unable to pay back the loan and lose their home in foreclosure.

The court rejected this contention noting that “[u]nder Illinois law, a lender ‘has no duty to refrain from making a loan if the lender knows or should know that the borrower cannot repay the loan.’”

In Price v. EquiFirst Corp., No. 1:08-CV-1860 (N.D. Ohio 04/01/09), it was alleged that the lender placed a consumer borrower into a mortgage loan “designed to benefit the [lender] to the detriment of the [borrowers]” entitling the borrowers to damages as a result of the lender’s “improvident lending.”

The court summarily rejected the improvident lending claim because the claim does not exist under Ohio law.

Similarly, when a cause of action was brought for improvident lending alleging that a lender closed on loans despite the borrower’s declining financial condition, the court held that no cause of action exists in either Delaware or New Jersey for improvident lending relying on the great weight of authority from other jurisdictions. (See Fedders N. Am., Inc. v. Goldman Sachs Credit Partners LP (In re Fedders N. Am., Inc.), 405 B.R. 527 (Bankr. D. Del. 2009).

Some recent decisions adopt status quo

Recent decisions are in harmony with prior decisions from across the country, which stand for the proposition that there is no duty owed to a borrower by the lender in underwriting a loan.

Such decisions include:

- St. Bernard Sav. & Loan Ass’n v. Robin Seafood, Inc., No. 91-4655 (E.D. La. 01/25/93).

Historically, contrary authority existed, but generally a duty was imposed only when the relationship went beyond traditional lender-borrower relationship. (See, e.g., Hill v. Equitable Bank, 655 F. Supp. 631 (D. Del. 1987), and Jacques v. First Nat’l Bank, 515 A.2d 756 (Md. 1986).

Decisions expand notions of lender’s duty

Despite the historical view, other recent decisions may reflect an expansion on the notions of the duty owed. Such decisions include:

- In Clark Motor Co., Inc. v. Manufacturers & Traders Trust Co., No. 4:07-CV-856, (M.D. Pa. 07/26/07), the borrower was an auto dealer that obtained a floor plan line of credit to finance its inventory. One of the borrower’s employees falsified the dealership’s records by falsifying the number of automobiles purchased so that the lender would provide financing for automobiles that were never received, allowing the employee to convert those funds for personal use.

The dealer brought an action alleging the lender was negligent for providing financing without verifying the collateral and providing financing through non-written phone requests. When the lender moved to dismiss because no duty was imposed by law, the court held that a duty ran from the lender to the borrower. As the court in LaSalle Bank Nat’l Ass’n v. Paramount Props., 588 F. Supp. 2d 840, 853 (N.D. Ill. 2008), later pointed out, the Clark court cited no precedent and provided no reasoning for its conclusion.


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represents an expansion of the duties owed in the lending context. The plaintiff was the seller of real property who fell victim to a foreclosure rescue scam.

As a result, the plaintiff brought an action against the lender for negligent underwriting, alleging that the lender failed to take measures to verify the borrower’s economic situation and to investigate the background of the parties involved in the transaction, thereby failing to prevent the transaction.

The court held that the pleadings were sufficient to withstand a motion to dismiss, adding:

Considering the present difficulties faced in the subprime mortgage market, a lender underwriting a mortgage has a duty to investigate and ascertain the economic status of the purchaser/mortgagor and whether the purchaser/mortgagor may be committing a fraud against the seller in the underlying transaction.

Similar to Clark, Mathurin did not cite any authority or provide an analysis for its creation of the duty owed by the lender. The Mathurin decision also appears to overlook precedent holding that no duty exists in the lending context. The following cases express that precedent:


As troubling as the creation of the duty is, even more troubling is the party to whom the duty is owed. The duty created in Mathurin is owed to the seller of the property in the underlying real estate transaction, not the borrower.

Contributory negligence in negligent underwriting context

To the extent that a borrower asserts a negligent underwriting claim against a lender, under proper circumstances is the borrower contributorily negligent in obtaining a loan that the borrower knew or should have known was unaffordable? Consider Audubon Meadow, where the court provided:

If, in truth, [a lender’s] methods of analyzing loan applications are deficient and result in imprudent decisions, shareholders are harmed, not borrowers or guarantors who presumably are cognizant both of the potential risks they encounter and their duty to repay the money loaned.” (Emphasis added.)

As more actions involving negligent underwriting claims play out in the courts and the claims gain footing, we should see how the contributory negligence defense fairs.

Improvident lending practices and the states

“Improvident lending” practices may also subject a lender to the scrutiny of states’ attorneys general. For example, in November 2008, the Massachusetts AG was granted a preliminary injunction after demonstrating to the court a likelihood that it would prevail on the merits for its claims that certain loans “were unfair because they were issued with reckless disregard of the risk of foreclosure,” an unfair act in violation of Massachusetts’ unfair practices statute. (See Commonwealth v. H&R Block, Inc., No. 08-2474-BLS1 (Mass. Super. Ct. 11/10/08).

The duty a lender owes to a borrower has also recently been expanded by state legislatures and regulatory agencies. Many state statutes and regulations now require lenders to give due regard for a borrower’s ability to repay. (See, e.g., Conn. Gen. Stat. §36a-760b; 205 Ill. Comp. Stat 635/5-6; Md. Code Ann., Co., Law §12-127; and 940 Mass. Code Regs. 8.06 (15).

The regulators of a majority of the states have also adopted the current administration’s Statement on Subprime Mortgage Lending and/or Guidance on Nontraditional Mortgage Product Risks, which provides for the use of reduced documentation loan underwriting only when mitigating factors are present.

It is also important to note that, come Oct. 1, 2009, Regulation Z will require a lender to consider a borrower’s ability to repay with respect to both high-cost and higher-priced home loans. Rules & Regulations Federal Reserve System, 73 Fed. Reg. 44522, 44603 (amending 12 CFR §226.34 (a)(4) and implementing 12 CFR §226.35).

State-law claims may be subject to preemption

The Homeowner’s Loan Act provides federal thrifts and savings banks with a unique defense against state-law claims for negligent underwriting, improvident lending, or violation of a state statute. Cedeno v. IndyMac Bancorp, Inc., No. 06 Civ. 6438 (JCK) (S.D.N.Y. 08/26/08), for example, held that HOLA preempted state-law unfair and deceptive trade practices act claims, as well as state-law breach of contract claims for making a loan based on an allegedly faulty appraisal, because they would impose state law requirements on the processing and origination of a mortgage.

Conclusion

It had been clear in most jurisdictions that without more, a claim sounding in negligence for negligent underwriting or improvident lending failed because a lending relationship does not create a legally recognized duty.

Recent case law has made this area less clear, however, as the notions of the duty a lender owes have been expanded by the courts. In addition, recent legislative and regulatory activity imposes a duty on a lender to examine a borrower’s ability to repay, which further raises questions regarding the duty a lender owes.

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