

CONSTRUCTION LENDERS MUST DISCLOSE INFORMATION TO TAKEOUT LENDERS

By Harris Ominsky*

A recent Arizona case explores the duties of a construction lender to disclose information to the permanent (takeout) lender about the financial condition of the Borrower. In Wells Fargo Bank v. Arizona Labors, Teamsters and Cement Masons Local No. 395 Pension Trust Fund, 38 P. 3d 12 (Az. Sup. Crt. 2002), the Supreme Court of Arizona has reversed a grant of summary judgment to a construction lender that failed to disclose the borrower's deteriorating financial condition to the permanent lender. The court held that even though the construction lender had no common-law duty to disclose the borrower's worsening condition, the construction lender could still be liable for an intentional tort or for breach of contract.

In that case, the permanent lender ("Fund") had alleged that the construction lender, "Wells Fargo," had deliberately delayed foreclosing against the borrower on an unrelated loan to buy time until the Fund paid off the construction loan. Also, that Wells Fargo did not disclose to the Fund that the borrower had submitted false financial statements to the Fund, and that Wells Fargo knew that the statements were false.

Tri-Party Agreement

The Supreme Court of Arizona reversed a summary judgment granted to Wells Fargo and held that the alleged conduct of Wells Fargo was enough to make it vulnerable to tort

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claims for aiding and abetting fraud, fraudulent concealment and tortious interference with contract, as well as a contract claim for breach of its duty of good faith and fair dealing.

The case revolves around a tri-party agreement entered into among the borrower, the Fund and the predecessor to Wells Fargo on the construction loan. Based on the permanent lender's commitment to take out the construction loan upon completion of construction of a project called "Mercado," Wells Fargo agreed to advance an interim construction loan of \$10,000,000. While tri-party agreements are not frequently used any more, the form used in the Wells Fargo Bank case was fairly typical at one time.

The Fund had conditioned its takeout obligation on a personal guaranty of the borrowers general partner, and production by the borrower and the guarantor of various financial statements of the borrower, its principals and its guarantors. Even though these parties were required to deliver financial statements, the bank had an obligation to furnish information to the Fund during construction of the project, such as existence of the liens, only if the Fund made a "reasonable request" for such information. The bank also agreed to inform the Fund of any default under the construction loan, or any intention by the bank to foreclose on that loan. The tri-party agreement stated that the bank had no other obligations in connection with the Fund's loan.

Wells Fargo's Conduct

During the construction period the borrower ran into trouble, not only with the Mercado project but also an unrelated project, Alta Masa Village, that had also been financed by the bank for \$2.3 million. When the Alta Masa loan matured, the bank extended the loan, and when the borrower was still unable to pay, the bank entered into a short-term

forbearance agreement with the borrower agreeing to delay any collection efforts on the Alta Masa project until after the “takeout” date when the Fund was to pay off the bank’s interim construction loan on the Mercado project.

The court in a long, detailed analysis of the facts, concluded that there was enough evidence that the bank had acted deliberately to cloak the borrower with a false appearance of financial vigor and to deprive the Fund of any reason to refuse to Fund the permanent commitment. In short, the court found that the Fund had raised enough material factual issues to require trial on the various theories put forward by the Fund. In arriving at that conclusion it rejected various defenses raised by Wells Fargo that had been adopted by the lower court. They included the following:

- The bank had no fiduciary duty of disclosure to the Fund;
- The tri-party agreement only required information upon the Fund’s “reasonable request;” and there had been no such request;
- The bank was not aware of any fraudulent activity by the borrower;
- The bank acted lawfully to protect its own interest when it postponed collection efforts on the Alta Mesa project;
- Despite the inaccurate financial statements, no event had occurred to the borrower’s financial status that would have given the Fund the legal right to refuse to honor the tri-party agreement; and

- The bank has a duty not to disclose confidential customer information.

The tri-party agreement had given the Fund the right to terminate if, among other things, the borrower was “generally not paying its debts as such debts become due,” or “became insolvent,” as that term is defined in . . . the “Bankruptcy Code”. The bank maintained that no event had occurred to the borrower which would qualify under the relevant bankruptcy statutes as failing to pay its debts “as such debts become due”.

The court disagreed with this and held that despite the loan extensions and the forbearance agreement, the Alta Mesa loan was absolutely in default and amounted to a clear failure to pay a debt when due. The court stated: “. . .If simple nondisclosure were the essence of this case, the Bank would not be liable, based on the holding in . . .” But, as discussed, simple nondisclosure is not the claim the Funds make. The real questions are the propriety of the Bank’s affirmative decision not to institute foreclosure proceedings against Alta Mesa, the forbearance, the failure to report Symington’s false statements to federal authorities, and whether these intentional actions or omissions interfered with the Funds’ right to receive from Symington information material to their decision to fund the Mercado loan.”

The decision for the Fund was made easier because of the conduct of the bank in connection with the Alta Mesa loan and because Arizona law implies a covenant of good faith and fair dealing in every contract. However, many other disputes under tri-party

agreements arise under circumstances where the construction lender does not have another loan with the same borrower, and many arise in states that do not apply that somewhat mysterious and vague standard of “good faith” to all contracts.

Conditions of Takeout

One of the lessons the case can provide to construction lenders is to negotiate carefully the conditions in a tri-party agreement that relate to the change of a borrower’s financial condition. A construction lender expects to rely on the permanent commitment to pay it off once the project is completed. It would like to know that all of the conditions of the takeout commitment are under its control. Therefore, if the construction lender has properly budgeted construction funds and supervised the job, it can have reasonable confidence that the project is completed to specifications within the designated deadline of the tri-party agreement. From the construction lender’s perspective, completion of the project in accordance with plans and specifications within a specified period of time is an appropriate condition to the takeout.

One of the issues frequently negotiated in these agreements is whether the risk of a borrower’s change of financial circumstances should fall on the construction or the permanent lender. That is a factor that is out of the control of the construction lender; and a cautious approach by the construction lender would be to resist any condition that relates to changed financial circumstances of the borrower. Despite that, the construction lender may have to concede that the takeout lender can walk away when the borrower goes bankrupt before the takeout closing. However, the bank should resist any other conditions

that would permit the takeout lender to wriggle off the hook if the borrower falls into default on other loans or if the borrower's financial condition deteriorates.

In this world of volatile stock markets, it is not unlikely that during a prolonged construction period, a borrower's net worth could rise, or fall by substantial percentages. A construction lender would not want that change of fortune to trigger a loss of its takeout loan. That is particularly true where permanent lenders are making the loan commitment and the credit decision based largely on the appraised value of the completed project, or on the credit of specified tenants who have accepted the completed construction project.

Although these details are not discussed in the Wells Fargo Bank case, it appears that the decision would have gone the other way if the bank had not permitted the takeout loan to be conditioned on contract provisions related to the borrower's changed financial condition.

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