The Importance and Limitations of Pre-Negotiation Agreements

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In the current economy which includes a tight credit market and depressed real property values, borrowers requesting and negotiating loan modifications or other loan workouts have become prevalent and necessary in order to avoid foreclosure. Often times when the lender does not approve a borrower's requested loan modification, many creative borrowers assert lender liability claims against the lender typically under the theory that the loan officer had orally "promised" them an extension or other loan modification during the negotiations. Legal theories that are asserted by borrowers against lenders in connection with such alleged oral promises range from breach of contract, promissory estoppel, fraud, negligent misrepresentation, breach of lender's duty of good faith and fair dealing and unfair business practices.

Many lenders now require the borrower (together with guarantors, if any) to execute a pre-negotiation letter agreement as a condition to commencing any loan workout discussions. The primary purposes of a pre-negotiation agreement are (i) to establish the ground rules for the negotiation of a possible loan workout, and (ii) to facilitate open discussion and negotiation between lender and borrower.

Common provisions in a pre-negotiation agreement

While the scope of a pre-negotiation agreement can vary considerably, common provisions that most lenders seek in a pre-negotiation agreement include an acknowledgment and agreement: (i) that lender is not obligated to negotiate or agree to any proposed loan workout and that lender may terminate negotiations at any time; (ii) that lender has not waived any of its rights under the loan documents during the negotiations; (iii) that any and all negotiations will not be binding until all terms are reduced to an executed written agreement; and (iv) that the negotiations are deemed settlement discussions and inadmissible pursuant to Evidence Code Section 1152 and Rule 408 of the Federal Rules of Evidence.

In addition, many lenders are using the pre-negotiation agreement as a tool to obtain affirmations favoring lender. For example, lenders commonly require the borrower to acknowledge and confirm (i) the amount of the outstanding debt (including default interest, late charges and other charges); (ii) the validity, scope and priority of lender's liens; and (iii) borrower's defaults. To most borrowers, such acknowledgments may seem non-objectionable and considered as harmless recitals of facts. However, most borrowers fail to realize that such acknowledgments or affirmations could be conclusively presumed to be true pursuant to Evidence Code Section 622 which expressly provides that "[t]he facts recited in a written instrument are conclusively presumed to be true as between the parties thereto or their successors in interest..."

Limitations of a pre-negotiation agreement

Notwithstanding the existence of a fully executed pre-negotiation agreement between lender and borrower, a recent case has shown that it may still be possible for the lender to be potentially liable for promissory estoppel claims under certain circumstances.

In *Garcia v. World Savings, FSB*, *183 Cal.App.4th 1031; 107 Cal.Rptr.3d 683 (2010)*, the Garcias owned a home that was subject to a foreclosure sale scheduled for August 29, 2007. On August 27, 2007, a mortgage broker representing the Garcias contacted one of the bank managers at World Savings to request a postponement of the foreclosure sale until the first week of September to allow enough time for the Garcias to refinance a separate property owned by the Garcias and to use some funds from such refinancing to bring the loan with World Savings current and reinstate such loan. The bank manager agreed to postpone the sale until August 30, 2007 and provided oral assurances that the property would not go to sale because he had the final say-so and as long as he knew that the refinancing could close in the first week of September, such bank manager would continue to postpone the sale as necessary.

In reliance on the bank manager's oral assurances or promise, the Garcias proceeded to refinance their other property as planned which refinance closed on September 7, 2007. The Garcias were unaware that the trustee on the World Savings trust deed sold the property at a foreclosure sale on August 30, 2007, an apparent mistake on the part of the bank manager. The Garcias subsequently sued World Savings for, among other claims, breach of contract and promissory estoppel. The court in *Garcia* rejected the breach of contract claim due to lack of consideration, but that the lack of consideration did not defeat a claim based on promissory estoppel. Under the doctrine of promissory estoppel, "a promisor is bound when he should reasonably expect a substantial change of position, either by act or forbearance, in reliance on his promise, if injustice can be avoided only by its enforcement." *Youngman v. Nevada Irrigation Dist., 70 Cal.2d 240, 249 (1969).* The court in *Garcia* held that the Garcias had a valid claim of promissory estoppel. The facts recited in the Garcia case did not reveal whether or not a pre-negotiation agreement had existed, but presumably one did not exist because otherwise World Savings would have raised that as a defense. Nonetheless, it is unclear whether or not the existence of a pre-negotiation agreement – one that explicitly provides that borrower may not rely on any oral promises and cannot raise any estoppel claims – would have altered the ruling in *Garcia.* Arguably, if all of the elements of a promissory estoppel claim are met, a pre-negotiation agreement may not be able to defeat such a claim. Therefore, lenders should maintain caution in their negotiations with borrowers and refrain from making any definitive assurances or promises that may reasonably induce detrimental reliance on the part of borrower.

Conclusion

A well-drafted pre-negotiation agreement can provide a lender with many protections from legal risks with respect to loan workout negotiations. However, based on recent case law it is possible that even with a pre-negotiation agreement a lender may still be potentially liable for promissory estoppel claims if lender makes any promises to borrower that reasonably induces or causes detrimental reliance on the part of borrower.

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