# Economic Downturn and Standard Contracts: Time for Another Look?

By Linda DeBene

Could new loan documentation provide processes for mutually acceptable decision making and resolution?

Every state's laws and practices are somewhat different. Nevertheless, much about commercial lending and financial affairs is based on general contract rules and drafting that are similar throughout the United States. Historically, on the East Coast, lawyers were always involved in closing lending transactions, whether commercial or residential. On the "opposite coast," a contrary mentality was prevalent as early as 1978. At that time, laypersons (albeit title employees, bankers and real estate professionals) ran the show in commercial real estate. William Shakespeare must have not only passed through but also stayed a while on the West Coast—all attorney participation had been "killed," as a character famously advises in *Henry VI*.[1]

Thirty years later in California (and in many other states as well), laypersons are expected to understand more and more paper: loan documentation, real estate contracts, financing documents and applications. Still, nonattorneys explain documentation to those laypersons. Loan applications (Fannie Mae Form 1003s), truth in lending statements (TILAs), real estate contracts, promissory notes, mortgages, deeds of trust and financing statements (UCCs) have been continually revised. These ever-growing preventative instruments cover a broad spectrum of legal regulations, disclosures, advisories and disclaimers.

A prime example of the growth in complexity is the real estate purchase and sale agreement published by the California Association of Realtors, which was a two-page form and is now a 10-plus–page document, including advisories, disclaimers and disclosure attachments. Another prime source for disputes comes from condensing an inches-thick printout of federal TILAs into one or two pages, presuming and assuming that borrowers fully comprehend what they are reading and signing (or just signing).

## Winner-Take-All Amid Economic Turmoil

In every contract dispute, there is a presumption that what borrowers, buyers, sellers or related plaintiffs/entities have signed, they are deemed to have read and understood entirely. California authority on this subject goes back to 1893 in the case of *Occidental & Oriental Steamship Co.*[2] and has continued to be solidly pronounced by the Supreme Court, the court of appeals and federal courts in California. With limited exceptions for fraud and "imposition" (overreaching adhesion contracts, for example), when a person with capacity of reading and understanding an instrument signs it, he or she is bound by its contents and is estopped from saying that its provisions are contrary to his or her intentions or understanding.

But this does not stop the lawsuits. We have to ask, why do lenders and borrowers, buyers and sellers, gravitate to litigation? No one is enamored about paying legal fees, not a soul appreciates the snail's pace of the judicial processes. But resolving disputes seems to draw out a need for public places (the courthouse), press coverage and finding justification (justice, as it is often called). Things do not always run perfectly. And when they do not, the people involved have a hard time talking about the issues with one another and, driven by self-protection, head

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off to adversarial ritual, rather than focusing on compromise, relationship protection and resolution.

Examining commercial and residential lending, title, escrow company and real estate transactions in California, and relating them to other states with similar practices, one can see that a large responsibility is placed in the hands of mortgage brokers and bankers (institutional lenders included here), title companies and real estate professionals. The interests of those responsible for commercial/residential lending are almost certainly adverse, if not diametrically opposed, to the borrowers, buyers and sellers. It is of heightened importance in our country now more than ever that mortgage brokers, mortgage bankers, financial institutions, title companies and real estate professionals are certain that the form contracts they are providing are not only just and conscionable (to avoid the exception to the rule) but also suitable and relevant for the parties and the times involved in them.

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Fortunately in the real estate arena, contract provisions have evolved over many years to provide alternative dispute provisions in order to prevent litigation imbalance when deals come into question.[3] Because of the nature of these contracts, buyers and sellers are placed on a more even playing field when it comes to managing conflicts.[4] Early alternative dispute resolution (ADR) processes, like mediation, provide an opportunity for an ADR provider to show those both familiar and unfamiliar with the judicial process that their case will not get any less expensive by litigation than by mediating to a compromise resolution.[5]

In the lending world that existed before September 2008, because of the normal winner-take-all public approach of often very strong (until very recently) lenders versus the weaker borrowers, traditional courtroom litigation, enforcing security agreements, repossession, judicial foreclosure or even nonjudicial foreclosure proceedings have failed to promote acceptable resolution solutions in a cost-effective manner. While winning litigation may have set a precedent, which the lenders believed gave them strength and prestige, litigation has failed utterly to provide viable relief in an economically failing atmosphere.

## A Time for Lenders to Review Standard Documentation?

View the current financial crisis: What contracts have promoted alternative resolution processes to aid borrowers in financial distress facing foreclosure, loss of their business lines of credit, job loss and loss of retirement savings and personal homes? Looking forward, could bank transactional counsel draft new loan documentation to provide processes for mutually acceptable decision making and resolution without having to fight the matter out in public from beginning to end, bringing shame on the parties and loss of revenue to all concerned?

Of course they can, but many will resist because to do so will individualize resolution. Other obstacles that have been given weight in the past will be thrown in the path of fairness and resolution: Banks should not be seen as being amicable to the "enemy" borrower; the bank will suffer delay in getting the property back and the borrower will benefit from that delay; banks do not believe borrowers' "stories"; the legal issues are too "big" for ADR and must be litigated; or "we do not want to talk, we want to fight to win."

Many have also been heard to say that there are disadvantages to some forms of ADR. For example, in the normal economic world we used to live in, building a mandatory mediation requirement into a loan foreclosure process would not aid efficiency to foreclose when a borrower was delinquent. In today's world, much positive publicity would have been gained by having such procedures in place to try to aid the many Americans who are caught up in the world of default and foreclosure by requiring lenders to mediate first, trying to come to a workout without delay and leaving houses occupied, not vacant.

But this brings the discussion back to the "big guy" versus the "little borrower" game. It can be turned positive with proper planning and drafting. Those "substantial legal issues" can be handled with a submission to a private neutral or to a stipulated or judicial referee, who can hear and decide the issue on a nonbinding basis without the delay of court accessibility. Early neutral evaluation by an industry-

experienced professional could be built in as a first quick step before a lawsuit, repossession, notice of default or judicial foreclosure can be initiated. If litigation is really required to get court intervention, record a notice of pending action or otherwise obtain an injunction, a special master or referee can be used to control discovery in the court proceeding so that the costs of the dispute do not engulf any recovery. Mediation and arbitration provide confidentiality and finality or can be structured to provide for private or judicial appeal[6] as the parties deem worthy to the issues.

## Savings Attributed to Mediation

In one appellate court in northern California, a forerunner in ADR that enacted a mandatory mediation program in 1999, participant evaluations required by the court compiled through July 2008 reflect that "parties have realized an estimated net savings of $53,488,782.00 since the program's inception" states John A. Toker, the program's first and recently retired administrator. There is no reason why ADR, which is such a positive thing for courts,[7] cannot overcome the old stumbling blocks thrown down by players such as lending institutions. The genuinely advantageous aspects of ADR—cost savings fiscal gain for all participants from which both lender and borrower can benefit, confidentiality and a just process where ongoing relationships in many instances can be preserved—far outweigh the negative, unduly expensive wars of the litigation processes, foreclosure or bankruptcy.

All have heard the cry in today's economic subprime turmoil for bankruptcy judges to have the power to modify loans in foreclosure or delinquent loans when borrowers are in bankruptcy.[8] Financial parties reject the idea out of hand. The recent federal "bailout bill" (TARP) was initially voted down by some members of Congress because there was no such provision. In the end, the final bill did not contain a provision for bankruptcy judges to modify mortgages as it was feared that such language would doom the rescue bill entirely.[9]

But why force the borrowers to file bankruptcy in the first place just to get relief, when a mediation-before-foreclosure provision could have the same effect and the bank personnel would be in charge of the reformations or negotiated settlements over payment terms, not a bankruptcy judge? Financial institution participants may forget or have overlooked entirely the fact that mediators do not make decisions. The parties in a mediation make the decisions to settle and negotiate to resolution. Mediation is no "cram down" but a way for parties to get together early to roll up their sleeves and try to come to a compromise that all can live with.

To defuse the drive/need to litigate as a defense mechanism, one should examine the alternative of avoiding court with a goal to cost savings (and increasing profit).

Litigation is not always the correct response to failed contract disputes. In the litigation process, the written document is publicized and everyone involved ends up with loss of face. Neither party gains any further fiscal superiority by litigating publicly, nor will the "open for all to see" arena create true profit—even though one party may prevail. The end result is that all parties may create more problems as a result of the public brawl. They could likely have upset employees and shareholders clamoring to sue directors and officers in huge class actions for breach of fiduciary duties. Insurance companies will be asked to defend and pay. Where does it all end?

Who will truly "win" litigation over a flawed contract that may or may not have been breached but that was "broken" from the inception? Certainly not either party in the long view of the events. Simply slapping documents together for one purpose, then adding to them Band-Aid provisions as tag lines as a result of each lawsuit that arises, should be seen as a thing of the past. As contracts are used and reused without thought or analysis of relevance to the existing market conditions, corporate officers and directors should stop and see how contracts can with forward thinking be appropriately drafted anew.

## Time to Reexamine Multipage Legalese

The times we are in today are perfect for financial institutions of all types to stop "killing" all their lawyers. They will be better served fiscally and in the eyes of the public at large to find the best and brightest among the lawyers to reexamine the multipage legalese of financial services contracts of all kinds. At a time when new loans are few and far between,

this is the time for forward thinkers to get busy on drafting customer/borrower documentation of all kinds, to re-write in-house operations manuals and to otherwise plan for a less litigious mind-set when dealing and contracting with customers.

Send in the transactional lawyers to sit down with each and every form contract and bring it back to reality, draft them so that they can be understood, bring the drafts to a focus group of real people who will be signing the forms and see if they are understood. Recent news commentary is replete with remarks such as: "s/he did not tell us how the form should be filled out," or "no one even understands what a derivative is," or "we cannot figure out exactly how loans were packaged into securities," or "we cannot track the loan documentation to where the real owner might be." These are scary things to a lot of folks and can be remedied so that the financial transactions of the post–September 2008 period rise to the realities of the new financial markets.

Companies of all kinds, including financial institutions small to large, face disputes from many sides: customers, employees, suppliers, shareholders, competitors, contracting parties. As is evident today, things are not always perfect, business falters, deals fall apart. ADR comes in a variety of flavors. Examine whether all of the various ADR processes are appropriate—not just arbitration so the institutions can try to avoid class actions. Avoid the "fight-to-the-death" mentality.

- **Early and impartial prevention can be built into company policy.** In reviewing the company's contracts, see if they have a method for discerning early disputes that are brewing. As in employment situations, bring in a neutral party to investigate and report on circumstances that could later result in class action filings. Look at internal rules and training programs. Set up conflict management processes to resolve conflict before the fighting starts rather than after. Hire a neutral party as ombudsperson or to give an early neutral evaluation of a developing issue.
- **Discovery is time-consuming, invasive and expensive.** Discovery statutes at the state and federal levels require sensitive information to be retained and disclosed. This can be embarrassing if made public. Continued press reports can harm a business's reputation, bring its financial ratings into a challenging arena and foster other litigation should one plaintiff prevail or the institution fails to prevail on a claim.
- **Most ADR processes are generally confidential.** Confidentiality not only makes it possible to avoid news coverage but also helps to bring parties to the table when they otherwise may not wish to be a party to a lawsuit over the matter.

Adopting proven alternatives to litigation in revised lending and financial documents are certain to result in monetary savings and fairness and will serve well the economic recovery process this country faces over the years to come.

## Endnotes

1 "... let's kill all the lawyers." William Shakespeare, HENRY THE SIXTH, Part 2, Act 4, Scene 2 (Boston: Houghton Mifflin Company, 1974), at 655.

2 99 Cal. 462, 471, 34, at 84, 87.

3 The real estate contracts in California published by the California Association of Realtors, a voluntary trade association of licensed brokers and agents who assist parties in purchasing and selling real estate, are still not perfect to all. Many lawyers complain that while the buyers and sellers are required to participate in mandatory mediation prior to arbitration or litigation, the brokers and agents are not so required. It is felt that this is not an equitable situation and permits the real estate professionals to stand aside and let the buyers and sellers fight over issues in which the real estate professionals have not only potential liability but a greater knowledge of factual issues. This debate has been going on for some time and is no nearer resolution today than a score of years ago. It is often the case, however, that brokers/agents (usually at the wise suggestion of company risk managers) will voluntarily join the mediation process, but this is in no way guaranteed.

4 *See* author's article, *Upholding the Honor and Dignity of a Promise, California Courts Speak: Stated Terms of Contracts Relating to Attorneys Fees "Mean What They Say,"* 3 LEXISNEXIS REAL ESTATE REP. 6 (Oct. 2008).

5 A recent article in the NEW YORK TIMES references an empirical study by Randall L. Kiser (coauthor and principal analyst at the litigation consulting company DecisionSet), now published in the JOURNAL OF EMPIRICAL LEGAL STUDIES, which discusses the economic inefficiencies of not settling cases and concludes that both plaintiffs and defendants make wrong decisions by not resolving cases prior to trial. Jonathan D. Glater, *Study Finds Settling Is Better Than Going to Trial*, N.Y. TIMES, Aug. 8, 2008.

[6] The California Supreme Court recently upheld an arbitration clause that provided for judicial review of an arbitration award as built into a contract between television equipment dealers and television service providers. *Cable Connection, Inc. v. DirectTV, Inc.*, 44 Cal.4th 1334, 190 P.3d 586 (2008). Conflicting California Supreme Court cases exist and were distinguished, with the Supreme Court relying strongly on the text of the specific arbitration provisions and warning "parties seeking to allow judicial review of the merits, and to avoid an additional dispute over the scope of review, would be well advised to provide for that review explicitly and unambiguously." *Id.*, at 1361.

[7] ADR programs preponderate in California trial, appellate and federal courts and are very much accepted and successful. Some are voluntary, some are mandatory. As another example, Florida appellate courts have had mandatory mediation for some time, in some instances running the program and supplying mediators under the court budget. In the mid-1980s, one Bay Area superior (trial) court was a pioneer of ADR processes. Designed by then Judge James Marchiano, now Presiding Justice of the California First Appellate District Court, Division One, various ADR programs broke the mold and are now duplicated in trial courts throughout California and elsewhere. In 1999, the California First District Court of Appeals promulgated a mandatory mediation program for civil cases. This program was energized with the initiative efforts of a former member of the same Bay Area superior court bench, Iganzio Ruvolo, now Presiding Justice of Division Four of the First Appellate District Court of Appeals and chair of that court's Mediation Program Committee. "Since July, 2007, the settlement rate for our program is over 70%," says recently retired First District Court of Appeals Mediation Program Administrator John A. Toker. Statistics reported in July 2008 for the 2007–2008 year reflected a continued rise in settlement rate over the life of the program to 70 percent over the prior year's 65 percent and an estimated savings to parties and counsel of over $8 million.

[8] The move continues to be proffered and rebuffed. In an article published January 8, 2009, a NEW YORK TIMES writer reported that Citigroup (which formerly had opposed such legislation) agreed to support legislation that would allow bankruptcy judges to adjust mortgage interest for "at risk" borrowers. On the other side, lobbyists for the financial industry vow to continue the fight against legislation proposed in Congress. *See* Carl Hulse, *Citi Reaches Deal With Lawmakers on Home Loans*, N.Y. TIMES, Jan. 8, 2009, *www.nytimes.com/2009/01/09/business/economy/09loan.html?ref=business.*

[9] *See Bailout includes no bankruptcy aid for homeowners*, L.A. TIMES, Sept. 29, 2008, *www.latimes.com/business/investing/la-fi-scrub29-2008sep29,0,2890645.story.*