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Payoff Letter Pitfalls for Commercial Lenders

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A borrower's request for a payoff letter on a secured commercial loan is typically a completely noncontroversial matter: an honest borrower has located a buyer for its property, or found another lender to refinance the borrower's debt, and needs a statement of the amount required to pay the debt and discharge the existing lien. In such cases, the lender prepares a payoff letter stating the amounts due on the loan, provides the letter to a title company or other closing agent, and the lender's loan is paid without incident.

How should the existing lender handle a payoff request in more unusual circumstances? For example, what is a lender to do when faced with a borrower who repeatedly demands payoff letters on a secured loan, but never provides the lender with any details regarding any proposed refinancing or sale? And what if that same borrower is in default on the secured debt, and the lender reasonably believes the borrower intends to sell the collateral to an insider for less than reasonably equivalent value? What if, in the midst of demanding payoff letters from the lender, the borrower fails to respond to the lender's questions regarding the location of the collateral? What if the borrower disputes the amount required to discharge the lender's mortgage or deed of trust, and threatens to sue the lender if the lender proceeds with foreclosure? In the face of such circumstances, is the lender required to provide a payoff letter at all and, if so, what information must the lender include? A lender recently faced these questions and ultimately won before the Missouri Court of Appeals in the case of Theresa Grisham, et al v. The Mission Bank.

Trial Court Ruling

The trial court in Grisham ruled that the Bank's letters to the borrower detailing the amounts due on the borrower's loans did not constitute a proper payoff letter and that the lack of such a statement prevented the borrower from closing a sale of the real estate collateral securing the Bank's loans. Based on that conclusion, the trial court found that the Bank's foreclosure on the real estate collateral was wrongful and awarded damages to the borrower.

Among the issues at trial were whether a lender is required to provide a payoff letter on a commercial

loan, and, if so, whether the Bank's letters in the Grisham case constituted proper payoff letters.

The trial court accepted the borrower's position that Missouri law does in fact require the delivery of a payoff letter on a commercial loan, without regard to the circumstances surrounding the request for such letter. The Bank had delivered letters stating the amounts due on the loans, but none of the letters contained any promise to release the Bank's liens upon payment. Further, the borrower argued that the Bank's letters overstated the amounts due on the various loans. Experts for the Bank and the borrower disagreed about the required elements of a proper payoff letter. The trial court sided with the borrower determining that the Bank's letters were insufficient, the lack of a proper payoff letter had prevented the borrower from selling the collateral and that the Bank therefore acted wrongfully by foreclosing on the collateral after the borrower failed to pay the debt as stated in the Bank's letters.

As to the question of whether the Bank was required to provide a payoff letter at all, the Bank's loan documents (as with most loan documents) were silent. No Missouri court had addressed whether there is a common law duty on lenders to supply payoff letters on commercial loans, and no Missouri statute required the Bank to do so. Moreover, the very few courts outside of Missouri to address the subject had determined that a lender does not have a common law duty to supply such a letter. Despite the lack of any such contractual, statutory or common law requirement, the trial court imposed a duty on the Bank to supply a payoff letter.

After deciding a payoff letter was required, the trial court was faced with the question of what information must be included in such letter. The experts for the borrower and the Bank disagreed, with the primary point of disagreement on whether a payoff letter must include a promise by the lender to release the lender's liens upon payment. Ultimately, the trial court did not resolve this dispute because the trial court, interpreting Missouri's statutory scheme governing the future advance deeds of trust held by the Bank, determined that the Bank's payoff letters overstated the amount the borrower was required to pay to discharge the liens. (Resolution of that payoff amount dispute is beyond the scope of this article, but will be the subject of an upcoming Lender's Edge article).

The trial court determined that the Bank's payoff letters, by overstating the amounts due, operated as a rejection of the borrower's "tender" of the amount that the borrower claimed was the correct amount required to discharge the Bank's liens. The borrower also argued that the Bank's rejection of the "tender" was ineffective because, according to the borrower, the Bank failed to adequately explain the basis for the Bank's rejection of the borrower's "tender." The trial court found that the Bank's rejection of the borrower's "tender" meant that the Bank's foreclosure after rejection of the "tender" was wrongful.

Bank Wins on Appeal

At the conclusion of trial, the court granted judgment to the borrower on, among other things, the borrower's claim for wrongful foreclosure. On appeal, the Bank prevailed. The appellate court ruled that the Bank's letters in fact had stated the correct amount required to discharge the Bank's liens, holding that the trial court erred by interpreting the Missouri statutes governing the Bank's future advance deeds of trust in such a way as to reduce the required payoff amount. The appellate court did not directly address whether Missouri common law would require a lender to provide a payoff letter on a commercial loan. However, the appellate court, following a well-settled principle of Missouri law, reversed the judgment on the wrongful foreclosure count because no such claims are permitted where the borrower was in default at the time that the foreclosure was commenced.

Future Guidance

Although the Bank ultimately prevailed, the case nonetheless provides some valuable guidance to lenders in future cases. First, even though there appears to be no case law requiring a lender to provide a payoff letter on a commercial loan, the prudent practice would be supply the borrower with such a letter, even in cases where the borrower is in default, where the location of lender's collateral is unknown or where a borrower does not provide refinancing or sale details. From a purely optics standpoint, the trial court seemed to be greatly influenced by the borrower's argument that the Bank had not supplied a proper payoff letter or adequately explained the reasons for the Bank's rejection of the borrower's "tender."

11 states have enacted statutes requiring a lender to issue some form of a payoff letter in connection with a commercial loan. Those states are: Arizona, California, Connecticut, Florida, Hawaii, Massachusetts, Nevada, North Carolina, Vermont, Virginia and Wisconsin. The required elements to be included in such letters, the consequences to the lender for failure to provide a payoff letter and the conditions under which the lender is required to issue a payoff letter vary among these states (for example, in two states the lender is not required to give a payoff letter after the lender has given notice of foreclosure). It is, of course, possible, that other states will in the future enact statutes requiring the issuances of payoff letters).

Second, lenders can help prevent disputes about whether its payoff letters are adequate by providing as much detail as possible – detail that will make it difficult or impossible for an opposing expert to credibly testify that the lender's letter does not contain all information required in a payoff letter. As was evident from the testimony of the experts in the Grisham trial, there is no universal agreement as to what information must be included in a payoff letter on a commercial loan. Lenders can help reduce risk of arguments on this point by including the following elements in their payoff letters: (a) the amount due; (b) the date through which the payoff amount is effective; (c) per diem amounts that will continue to accrue after such date; (d) wiring and other payment instructions for payoff; (e) a statement of the conditions required for lender's lien release; and (f) a statement that the lien will be released upon compliance with the lender's requirements. Further, the letter should be issued by the lender rather than lender's counsel, and the letter should be delivered to the title company or other closing agent in addition to being delivered to the borrower.

Third, where a borrower offers to pay less than the outstanding indebtedness, a lender should provide a detailed explanation for its disagreement with the borrower's calculations or otherwise explain the lender's reason for rejecting the borrower's proposal to pay such discounted amount. The lender should provide its reasons even where it is apparent that the borrower does not have the ability to actually deliver the amount "tendered" by the borrower. Again, from an optics standpoint with the court or the jury, the lender will look more reasonable if it explains the reasons for its rejection of the borrower's payment proposal. Further, the lender's failure to explain the reasons for its rejection of a tender may result in a waiver of the lender's objections to the tender.

In summary, a borrower's request for a payoff letter on a commercial loan, while usually uneventful and non-controversial, presents a number of risks to the lender. Lenders, however, can minimize their risk by taking the steps described in this article.

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