

# Buchalter

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## IT MAY BE LEGAL, BUT IS IT *UNCONSCIONABLE* AND NOT ENFORCEABLE?

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12:00 Noon

May 15, 2019

Webinar

BUCHALTER

1000 Wilshire Boulevard, Suite 1500

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IT MAY BE LEGAL, BUT IS IT *UNCONSCIONABLE* . . . ?

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I. INTRODUCTION

## II. WHERE IS THE AUTHORITY FOR **UNCONSCIONABILITY**?

- *Restatement of the Law, Contracts 2d, Section 208 “Unconscionability Contract or Term”* provides as follows:

If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable terms, or may so limit the application of any unconscionable term as to avoid any unconscionable result. (Emphasis added.)

- *Uniform Commercial Code (U.C.C.) § 2-302, “Unconscionable Contract or Clause”*, provides as follows:

(1) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result. (Emphasis added.)

(2) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.

## II. WHERE IS THE AUTHORITY FOR *UNCONSCIONABILITY*?

### (cont.)

- *California Civil Code § 1670.5*, "Unconscionable contract," provides as follows:

(a) If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionability clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result. (Emphasis added.)

(b) When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.

## II. WHERE IS THE AUTHORITY FOR **UNCONSCIONABILITY**?

### (cont.)

- *Case law (First Alternative)*

California law recognizes two alternative analyses for determining whether a contractual provision would be unenforceable because it is unconscionable.

In the leading case of *Patterson v. ITT Consumer Financial Corp.* (1993) 14 Cal. App. 4<sup>th</sup> 1659, 1663, the Court of Appeal held as follows:

The first model set out in *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807 [171 Cal.Rptr.604, 623 P.2d 1651] **asks initially whether the contract is one of adhesion.** (*Id.* at p. 819.) Since a contract of adhesion is still fully enforceable, the inquiry then turns to whether enforcement should be denied. First, enforcement will be denied if the contract or provision **falls outside the reasonable expectations of the weaker party.** (*Id.* at p. 820.) Second, enforcement will be denied even if it does fall within the reasonable expectations of the parties, but **it is unduly oppressive or unconscionable.** (*Ibid.*)

## II. WHERE IS THE AUTHORITY FOR **UNCONSCIONABILITY**?

### (cont.)

- *Case law (Second Alternative)*

The alternative analytical model was set out in *A & M Produce Co. v. FMC Corp.*, *supra*, 135 Cal.App.3d 473. It sought to define what rendered a contract or a contractual provision unconscionable and hence unenforceable under Civil Code section 1670.5. (135 Cal.App.3d at p. 485.) *A & M* concluded that unconscionability has a procedural and a substantive component. (*Id.* at p. 486.)

The **procedural component** focuses on the factors of oppression and surprise. (*Ibid.*) Oppression results where there is no real negotiation of contract terms because of unequal bargaining power. (*Ibid.*) "'Surprise' involves the extent to which the supposedly agreed-upon terms of the bargain are hidden in a prolix printed form drafted by the party seeking to enforce the disputed terms." (*Ibid.*) The **substantive component** of unconscionability looks to whether the contract **allocates the risks of the bargain in an objectively unreasonable or unexpected manner.** (*Id.* at p. 487.) To be unenforceable there must be both substantive and procedural unconscionability, though there may be an inverse relation between the two elements. (*Ibid.*)

### III. PROCEDURAL UNCONSCIONABILITY.

- Procedural **unconscionability** may be summarized as follows:

Procedural unconscionability focuses on “oppression” and “surprise.” *A&M Produce*, 135 Cal. App. 3d at 486. A finding of oppression is appropriate when there is an “inequality of bargaining power which results in no real negotiation and ‘an absence of meaningful choice.’” *Id.* (quoting *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449, 121 U.S. App. D.C. 315 (D.C. Cir. 1965)). “‘Surprise’ involves the extent to which the supposedly agreed-upon terms of the bargain are hidden in a prolix printed form drafted by [\*16] the party seeking to enforce the disputed terms. *Id.*” *Garcia v. Trademark Construction Co.* (2019 C.D. Calif.) 2019 U.S. Dist. LEXIS 48322 (emphasis added).

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## LOAN GUARANTEES: *HEDGING AGAINST A DOWNTURN*

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#### IV. SUBSTANTIVE UNCONSCIONABILITY.

- Substantive **unconscionability** may be summarized as follows:

*Substantive unconscionability* exists when a contract has "**overly harsh** or **one-sided results**." *Armendariz*, 24 Cal. 4th at 114 (citations and quotations [\*18] omitted). Substantive unconscionability, however, "requires a **substantial degree of unfairness beyond 'a simple old fashioned bad bargain'**." *Sanchez*, 61 Cal. 4th at 912 (quoting *Sonic-Calabasas A, Inc. v. Moreno*, 57 Cal. 4th 1109, 1160, 163 Cal. Rptr. 3d 269, 311 P.3d 184 (2013)). Instead, only "one-sided contract provisions" that are "overly harsh," "unduly oppressive," "unreasonably favorable," or that "**shock the conscience**" are unconscionable. *Id.* (citing *Pinnacle Museum Tower Ass'n. v. Pinnacle Mkt. Dev. (US), LLC*, 55 Cal. 4th 223, 246, 145 Cal. Rptr. 3d 514, 282 P.3d 1217 (2012)). The "ultimate issue in every case," therefore, "is whether the terms of the contract are **sufficiently unfair**, in view of all relevant circumstances, that a court should withhold enforcement." *Id.* at 912. *Id.*" *Garcia v. Trademark Construction Co.* (2019 C.D. Calif.) 2019 U.S. Dist. LEXIS 48322 (emphasis added).

**V. A LOAN PROVISION MAY BE LEGAL, BUT IT MAY BE UNENFORCEABLE BECAUSE IT IS **UNCONSCIONABLE**.**

- While a loan provision may be legal, the lender may not be entitled to enforce it, if a court should determine that the provision is **unconscionable**.

In *Baldwin Lynch Energy Corp. v. Schlumberger Tech. Corp.* (D. Mont. 2013, 2013 U.S. Dist. LEXIS 200444), **unconscionability** was described as follows:

"**Unconscionability**" refers to "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party." [Citation.] . . . the doctrine of **unconscionability** has both a **procedural and a substantive element**, the former focusing on **oppression or surprise** due to unequal bargaining power, the latter on **overly harsh or one-sided results** . . ."

"Both **procedural and substantive unconscionability must be present** for the court to refuse to enforce a contract under the doctrine of unconscionability although "they need not be present in the same degree." . . . **Essentially, the court applies a sliding scale** to the determination: **"[T]he more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa."**

- Note: Read your loan provisions as if you were a judge or a jury during a trial.

## VI. WHEN IS IT DETERMINED WHETHER A LOAN IS **UNCONSCIONABLE?**

- *While it is possible that a loan provision may not be unconscionable at the date that the loan is made, it may, by a change of circumstances, later become unconscionable.*
- *However, the authorities are of the position that unconscionability is only determined “. . . at the time the contract was made . . . .” See, California Civil Code § 1670.5; Uniform Commercial Code § 2-302(); and Restatement of the Law, Contracts 2d, Section 208.*
- *As a Practical Matter: It is at any time.*

**VII. FACTORS WHICH MAY TEND TO INCREASE THE RISK THAT A LOAN PROVISION MAY BE FOUND TO BE **UNCONSCIONABLE**.**

- There are a variety of factors which may tend to increase the risk that a loan provision may be found to be **unconscionable**. These factors include the following:
  - A. Language
  - B. Age
  - C. Education
  - D. Representation by counsel or an advisor
  - E. Lack of alternatives
  - F. Presence of Disabilities
  - G. Borrower's Financial Condition
  - H. Health
  - I. Experience
  - J. Lack Of Demonstrable Economic Risk To The Lender
  - K. Purpose of the Loan
  - L. Advertising
  - M. Loans Purchased From Others
  - N. Timing
  - O. Conduct of the parties

**VIII. FACTORS WHICH MAY TEND TO DECREASE THE RISK THAT A LOAN MAY BE FOUND TO BE **UNCONSCIONABLE**.**

- A variety of factors which may tend to decrease the risk of **unconscionability**:
  - A. Language
  - B. Age
  - C. Education
  - D. Representation by counsel or an advisor
  - E. Available of alternatives
  - F. Lack Of Any Disabilities
  - G. Borrower's Financial Condition
  - H. Health
  - I. Experience
  - J. Risk To The Lender
  - K. Purpose of the Loan:
  - L. Advertising
  - M. Loans Purchased From Others
  - N. Timing
  - O. Conduct of the parties
  - P. Good Practices

**IX. IF YOU ARE FACED WITH A CLAIM THAT A LOAN PROVISION IS ALLEGEDLY **UNCONSCIONABLE**, WHAT ARE APPROPRIATE RESPONSES?**

- Lender should advise claimant that, without waiving any of its rights, it will review the claims made.
- Lender and counsel should promptly conduct and diligently pursue a thorough, fair and objective investigation into the allegations of **unconscionability**.
  - Review the loan file
  - Review the desk file
  - Review the emails
  - Review any other documents that would be subject to discovery in a lawsuit
- Lender should only communicate in writing with its **lawyer**. Otherwise, you are just **creating exhibits** for the borrower or guarantor to use against you.
- All other communications should be carefully considered as the lender may be creating witnesses to be deposed in litigation.

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## **X. CAN AN INTEREST RATE ON A LOAN BE UNCONSCIONABLE?**

- *De La Torre v. CashCall, Inc.* (2018) 5 Cal.5th 966.

The California Supreme Court held that an interest rate on a loan, like any other loan term, may be unconscionable, even though it is not unlawful. In that case the Lender was allegedly lending “. . . at an interest rate of 90% or higher . . . .”

- *Carboni v. Arrospide* (1991) 2 Cal. App. 4th 76.

The Court of Appeal found that a secured loan with a 200% interest rate: (1) was substantively unconscionability because the 200% interest rate imposed “. . . a cost on the borrower which is overly harsh and was not justified by the circumstances in which the contract was made” and, (2) was procedurally unconscionable because there was “. . . an inequality of bargaining power which effectively robbed . . . [the borrower] of any meaningful choice.”

Note: *East West Bank v. Altadena Lincoln Crossing, LLC* (C.D. CAL. 2019) 2019 U.S. Dist. LEXIS 36200 (upholding propriety of default interest provision)



**XI. CAN A FEE OR CHARGE ON A LOAN BE **UNCONSCIONABLE**?**

- Fees charged by Lenders to Borrowers and other customers had been a frequent target of claims of alleged **unconscionability**.
- In *Purdue v. Crocker National Bank* (1985) 38 Cal.3d 913, the California Supreme Court found that **a bank depositor who was charged \$6 by the bank for the processing of checks drawn on accounts without insufficient funds could state a cause of action when the customer alleged that “. . . the actual cost incurred by defendants in processing an NSF check is approximately \$0.30”** thirty cents.
- Therefore, in setting fees to be included in loan documents, consideration should be given to the “*reasonableness*” of the fee and how the fee relates to actual cost or risk to the Lender. **Any such analysis should be made with counsel so that the analysis should be privileged.**

## **XII. CAN A NOTICE PROVISION IN A LOAN BE *UNCONSCIONABLE*?**

- Loan documents frequently include a provision whereby either the Lender, the Borrower or Guarantor provides notice to one another. Frequently the loan documents will describe how the notice must be given (i.e. United States Postal Service, Personal Delivery, etc.).
- How long is the notice period?
- Is the notice period accounted for in calendar days, court days, business days, or...?
- How is notice to be provided? Mail, FedEx, personal delivery, email, or...?
- Where are the respective parties located?
- Is the notice period different for a borrower as opposed to a guarantor?

### XIII. CAN A “CURE” PROVISION IN A LOAN DOCUMENT BE **UNCONSCIONABLE**?

- Loan documents frequently provide a Borrower or a Guarantor with an opportunity to “cure” a default in a loan agreement. Depending upon the nature of the default, the Lender may be required to provide notice to Borrower or Guarantor of the existence of the default and to request that the default be “cured” consistent with the provisions of the loan agreement.
- Similar to the notice requirement, the Lender should carefully review the loan documents to make sure that any notice to the Borrower or Guarantor of the need “cure” a default and the time allowed for the borrower to “cure” the default is realistic and cannot be attacked by the Borrower or Guarantor as allegedly being **unconscionable**.

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**XIV. CAN ALTERNATIVE DISPUTE RESOLUTION PROVISIONS IN A LOAN DOCUMENT BE **UNCONSCIONABLE**?**

- **Jury Trial Waiver**: In some states, such as California, a jury trial waiver without any more is unenforceable. See, *Grafton Partners L.P. v. Superior Court* (2005) 36 Cal. 4th 944.
- **Arbitration**: Depending upon how the arbitration provision is drafted and the circumstances under which it is executed it may or may not be enforceable. See, *Patterson v. ITT Consumer Financial Corp.* (1983) 14 Cal. App.4th 1659.
- **Mediation**: The Lender must consider the selection of the mediator, the place of mediation, the cost, and the mediation rules.
- **Judicial Reference**: By careful drafting of the loan documents, the Lender should be able to provide for an enforceable judicial reference provision. See, *Woodside Homes of California, Inc.* (2003) 107 Cal. App.4th 723. Of course, the Lender should avoid provisions in the judicial reference which makes it unduly burdensome for the borrower.

**XV. CAN A BID AT A FORECLOSURE SALE OF A LOAN SECURED BY A DEED OF TRUST BE **UNCONSCIONABLE**?**

- **Full Credit Bids v. Unreasonably Low Bids:** See, e.g., *Crosby v. ALG Trustee, LLC* (2018) 822 S.E.2d 185 (the prevailing bid was “. . . so grossly inadequate as to shock the conscience of the court”)
- **Condition of The Property:** Before the foreclosure sale the Lender should take appropriate measures to adequately determine and document the condition of the property.
- **Value of The Property:** Take steps to avoid improvident full credit bids or unreasonably low bids without taking into consideration the actual value of the property.
- **Title:** If the Lender does not have an undisputed first priority lien on the Borrower’s property, that should be appropriately documented. If there are other defects in the title (i.e., easements) which would cause the Lender to make a reduced bid those, too, should be appropriately documented.
- **Environmental:** Before the foreclosure sale an appropriate environmental assessment should be made of the property.

**XV. CAN A BID AT A FORECLOSURE SALE OF A LOAN SECURED BY A DEED OF TRUST BE **UNCONSCIONABLE**?**  
**(cont.)**

- **Nature Of Lien Determines Bidding Strategy:** Presuming the Lender can adequately determine that it has a valid and enforceable and unquestioned first priority lien on the property, the Lender should have a minimum opening bid of at least 20% to 30% of its equity in the property.
- **Other Considerations For Bidding:** Is there competitive bidding? Is the Lender is subject to being redeemed by another interest (Internal Revenue tax lien) it may be necessary to increase the bid above the initial level.
- **Foreclosing Lender's Attempts to Publicize the Foreclosure Sale:** Consideration should be given by the Lender to publicizing the foreclosure sale by more than the minimum legal requirements. This is especially true on "difficult" properties where it is anticipated that there may be few bidders.
- **The Borrower's and the Guarantor's Perspective:** Provide "additional" notice of the sale in writing.

**XV. CAN A BID AT A FORECLOSURE SALE OF A LOAN SECURED BY A DEED OF TRUST BE **UNCONSCIONABLE**?**  
**(cont.)**

- **The Lender's Perspective:** There must be an adequate bid, under all of the circumstances. If the Lender is of the opinion that a bid of less than 20-30% of its equity in the property is appropriate, that should be well documented.
- **The Loan Servicer's Perspective:** Depending upon the terms of the loan servicer's agreement the loan servicer may be the decision maker with respect to the foreclosure. Accordingly, all of the factors considered by the Lender should be considered by the loan servicer.
- **The Foreclosure Trustee's Perspective:** The principal objective of the foreclosure trustee should be to conduct a foreclosure sale which is open and free of any apparent or potential improprieties.
- **Amount of Bid:** Assuming a first priority lien, it is customarily recommended to be between 20 and 30% of the equity in the property. Depending upon a variety of factors, a lower bid may be appropriate. However, except in the case of competitive bidding or a risk of redemption (an IRS lien), a "full credit bid" is rarely appropriate.



**XVI. CAN LIMITS ON RECOVERABLE DAMAGE IN A LOAN DOCUMENT BE UNCONSCIONABLE?**

- Attempts to limit potential liability, specifically liability for consequential damages, depend on applicable state law and may be deemed **unconscionable**.

*See, In Baldwin Lynch Energy Corp. v. Schlumberger Tech Corp.* (U.S. Dist. Mont. 2013) 2013 U.S. Dist. LEXIS 20044 (Montana law did “. . . not preclude two business entities with equal bargaining power from contracting to limit their respective remedies and liabilities”)

*In contrast, see, A&M Produce Co v. FMC Corp* (1982) 135 Cal.App.3d 473 (upheld a jury verdict against an agricultural equipment company where the trial court had ruled that clauses in the defendant’s preprinted contract “. . . excluding consequential damages were **unconscionable** . . .”

## **XVII. CONCLUSION**

- Review your loan documents.
- Make notice and cure provisions reasonable.
- Make ADR, jury trial and/or judicial reference provisions reasonable.
- Utilize appropriate foreclosure strategies, including bidding.
- Appropriately investigate all claims of **unconscionability**.
- **RSVP for our next presentation: Loan Guarantees: Hedging Against A Downturn – September 25, 2019 at noon.**

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