

Five Common Pitfalls Hard Money Lenders Must Avoid to Reduce Risk and Protect Their Deals

March 24, 2026

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This article details five pitfalls hard money lenders' teams face when working on potential deals. Detailing these pitfalls is intended to be a useful guide for those new to the industry (and want to avoid costly mistakes) and, for more experienced people in the industry, a helpful reminder of the biggest red flags everyone must be vigilant about when working on deals.

The business of hard money lending carries enormous risk. Starting out requires raising sufficient capital to lend and navigating the thicket of licensing requirements and regulations that apply to hard money lenders (an endless process due to ever-changing regulations in the industry).

Once established, however, hard money lenders, and their teams, have to maintain the standards they set for each deal that gets onboarded. From the sales stage through underwriting to closing, mistakes, indiscretions, and oversights may occur, and some of those errors have very costly consequences.

If there is one thread tying together each of these five pitfalls, it is: know your borrower—and especially so if it's an entity. Here are the five pitfalls.

For borrowing entities, failing to properly evaluate and research individual members.

When the borrower is an entity, the individual owners of that entity must be evaluated thoroughly.

Hard money lenders, although they are not financial institutions in the same vein as major banks, are subject to the same requirements that the Bank Secrecy Act imposes. Those requirements include an obligation to file a suspicious activity report (SAR) with the United States Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) for transactions that are suspicious and raise questions as to whether the transaction is an attempt at money laundering. Similarly, FinCEN requires that hard money lenders maintain an anti-money laundering program with written procedures, personnel responsible for day-to-day operations, employee training to detect suspicious activity, and testing and review of the program.

For each owner of the business entity, it is crucial to run a background search on that individual. Vetting individual owners of the borrower entity is not only important for understanding who is effectively the borrower; it is also essential for the lender to comply with the Bank Secrecy Act's requirements.

Sometimes, an individual working for the lender does not realize the consequences of missing a detail like this. The most common consequence in this type of situation is an audit.

If the lender faces an audit—whether from FinCEN or a state licensing authority—and that audit reveals the lender missed a

red flag related to a borrower and its individual owners, the consequences can be significant. Although an audit can result in a timeframe for the lender to take corrective action, regulators also may impose fines and civil penalties, issue cease-and-desist orders requiring the lender to stop its lending activities, require loan rescissions or restitution, or pursue more frequent audits.

That range of consequences coming from an audit may be daunting, but regardless of the result, it means taking resources and time away from deals and instead diverting those into managing audit responses and working with counsel to mitigate the negative consequences.

For borrowing entities, not confirming the signatory has the authority to bind the entity.

For any type of business entity, whether a corporation, limited liability company, or another type, it is crucial to ensure that the lender knows the signatory has the authority to sign documents on behalf of the entity.

Typically, during the onboarding phase, the entity will have provided an operating agreement and a resolution authorizing the person to sign on behalf of the entity. Reviewing that operating agreement's terms to verify the process it sets out for passing a resolution is a step that too often gets overlooked. Connecting each dot, from the company's formation to its operating agreement setting out how a resolution may be passed, to having a resolution appointing the signatory, is necessary for any deal involving a borrower entity.

If there is no follow-through on this step, the lender's position becomes perilous for clawing back the funds it lent. In short, if the signatory did not have authority to sign, the loan documents are essentially meaningless, and the lender has virtually no recourse.

A signatory lacking authority does not just arise where there is fraud.

For example, if there is a dispute among the owners of the business entity regarding the operations of that entity, and there is a potential buyout or sale of an owner's interest in the entity, that may end up affecting the lender's loan. To avoid being caught in the middle of such a dispute, the lender, at the time of the loan, must clearly establish that the person signing on behalf of the borrowing entity had authority to do so and then maintain copies of those documents.

If there is any dispute about the signatory's authority to sign, then it may lead to a court deeming the loan documents and any guaranties invalid and unenforceable. The debt would thus not be collectible, and foreclosure on the property—the most effective way for the lender to pursue collection, if not the only way—becomes impossible. In many cases, the lender will be able to conclude that the debt is not collectible only after commencing a lawsuit seeking to enforce the loan documents and pursue a foreclosure of the property. It is only after incurring legal fees, expenses, costs, and time that a court would then potentially declare the documents to be unenforceable and leaving the lender with a loss on the loan and then the fees, expenses, and costs incurred.

For borrowing entities, not confirming the structure of sub-entities.

When the entity is a borrower with sub-entities, it is necessary to understand the owners of the sub-entities, as well as the layout of those sub-entities.

Often, when there are sub-entities, there are specific, easily identifiable reasons, such as being a family business that incorporates family members' interests. Other times, a web of sub-entities can be used to hide the true ownership of the borrowing entity, conceal financial problems with that entity, shield individuals known to be bad actors, or launder money.

Those same requirements coming from the Bank Secrecy Act, the anti-money laundering programs and suspicious activity reports come when analyzing the sub-entities for a borrower. Every individual owner associated with the sub-entities should have a background check performed, and there should be clarity about the structure and all the individuals involved with the business.

As with other failures to comply with the Bank Secrecy Act and other such regulations, one of the most common consequences is an audit. As detailed above, that audit may be very disruptive to the lender's operations.

Overlooking open judgments and liens.

Thoroughly reviewing active litigation, unpaid judgments, and open liens is critical to evaluating the viability of the loan.

If there is active litigation, reviewing the documents filed in that litigation is necessary to understand how it might impact the deal. That litigation may impact the real estate or the borrower's business. As to the real estate, neighbors could have filed lawsuits that are seeking access to portions of the property or restrictions related to the property. Lawsuits like that could not only affect the salability of the property; they could also affect the lender's rights to the property even if it foreclosed on the property and sought to sell it afterward.

But, most often, it will affect the lender's priority of lien on the property.

When there are multiple liens on the same property, the priority of lien dictates who gets paid first when the property is sold, either at foreclosure or just on the market. Many times, the value of the property may only pay off the first loan, or even part of the second loan. If the lender's lien is second, third, or fourth priority, then the lender may end up totally empty-handed when attempting to collect the loan.

Failing to verify the legitimacy and contents of bank statements or other documents submitted by borrowers.

Lenders' guidelines for loans require the borrower to submit bank statements and other documents to verify the borrower's qualifications for the loan. These are helpful mechanics for ensuring the borrower is capable of repaying the loan.

Sometimes, however, borrowers engage in fraud or other unlawful activity leading them to submit documents that are either entirely fabricated or partially doctored and tailored to meet the lender's requirements. Reviewing those documents through the lens of common sense can go a long way in revealing that they are false. When documents are suspicious or simply do not add up, it becomes important to make additional requests for documents that corroborate those already submitted and come from third parties over which the borrower has no control. Ideally, the lender maintaining these standards roots out fraudulent documents prior to the closing.

For most hard money lenders, an overwhelming majority of the closed loans are then sold to private capital providers/secondary market buyers or to institutional private credit funds, such as private equity funds or hedge funds. When each loan is sold, there are representations and warranties about the loan that the lender makes to the purchaser. Those representations and warranties virtually always require the lender to buy the loan back if there is any fraud, regardless of whether the lender knows of the fraud. If, for example, the bank statements were fake and the borrower defrauded the lender, the lender would be obligated to buy back that loan. Then, if a loan is bought back, the lender would have to service the loan and take steps to collect it. This would be a highly burdensome process for a lender to undergo and would divert resources away from new deals.

Conclusion

Although these are not the only pitfalls that hard money lenders face, they are the most common and guarantee outsized consequences. Every member of the lender's team needs to be aware of not only these pitfalls but others as well, to ensure that the deals being closed are the right ones.