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## LENDER LIABILITY LURKS BEHIND TODAY'S CRISIS

Risks lie not only in what you've told errant borrowers,

but in what you've let them get away with in better times

In my nearly 45 years as a banker, lender liability has been particularly topical twice—including right now.

The Farah case, and its unfortunate effect

The first time in my memory was in the late 60s. It involved a group of banks in Texas and a clothing manufacturer, Farah Manufacturing Company. There were several issues in the Farah case, but the one that bankers of my generation remember best revolved around the extent of control that the lead bank exercised over the day-to-day affairs of the borrower.

Banks, as lenders, can be quite intrusive. Ask most any borrower. We take collateral, occasionally inspect it, monitor the company's activities, insist on periodic financial statements and require the borrower to adhere to certain conditions, financial and otherwise, to avoid a default. The list of what we will permit the borrower to do or not do can be quite extensive.

But not all of what we do is illegal nor is it necessarily unwelcome by the borrower.

Normally, these are reasonable and necessary precautions for prudent lending and protections for the risks that our banks are assuming. These conditions are enumerated and agreed to, as the loan is negotiated.

Problems have occasionally arisen from bankers exceeding the boundaries of their rights or authority and "overstepping" what they are contractually permitted to do. This is what happened in the Farah case.

Among other things, the court determined that as the company's financial condition deteriorated, the banks exercised day-to-day influence over the management of the company.

Most of us have been asked for our advice on a customer's problems or opportunities; but in the Farah case, the banks apparently went too far and the borrower had been damaged by faulty and unsolicited advice.

The result for many years was an unfortunate reluctance of bankers to tender any advice, solicited or not, to the

borrower. Nearly a generation of borrowers was cut off from potentially useful input from their bankers, on the advice of counsel, and perhaps from bankers' excessive caution in their understanding of the issues of the case.

The message simply stated was that if you give lousy advice and the customer suffers financially as a consequence, you'll be sued.

Lender liability can arise beyond loans

Lender liability has arisen, at least in my recent awareness, from a new set of causative factors. In its latest predominant version, it's the lender taking some specific action, frequently drastic, that was unexpected and caused the borrower considerable distress or hardship.

Here's a case I was involved with where litigation was a distinct risk.

A commercial borrower at one of our large branches had run into considerable cash flow difficulties. These had accumulated over a period of several months. They were known to Judy, the branch manager, a woman of 30-plus-years experience, normally sound judgment, and a generous heart.

The customer was current on his commercial term loan and was paying as agreed. What no one at headquarters knew (e.g., Loan Review or Branch Administration) was that Judy had permitted the customer to accumulate a negative balance to a more-or-less continuous low five-figure amount. This was within the letter of her authority but we had become careless in watching for chronic overdraft situations.

That happens sometimes when business is good.

One day, someone in branch administration issued an "edict" on overdrafts. I don't remember what precipitated the action nor was I consulted in advance.

But the edict caught Judy's customer in the cross hairs. Effective with the next day's business, any account continuously overdrawn for more than a certain number of days (a great many fewer than Judy's customer had enjoyed) would have all further checks presented against overdrawn balances returned.

To interrupt that source of "back door" financing would have buried the company, by the reaction of its creditors, who, by this time, would be creditors by virtue of NSF checks. We had permitted this practice for months, the customer had relied on it, and I'm not sure what promises Judy might have made to the customer as the overdrafts continued and grew.

To stop the overdrafts cold would have been contrary to our previous practice and clearly have been very disruptive to the business. Fortunately, we saw the potential for mischief and took an alternative course.

First thing we did was to rewrite the commercial loan, wrapping up the overdraft balance in the new principal amount. We had a "Dutch uncle" talk with both Judy and the borrower and made it clear that no more overdrafts would be permitted. The borrower had time (months instead of hours) to make some painful but necessary adjustments and life

for him and us went on.

But it could have been very painful all around and embarrassing for us as well. Imagine the stakes to the bank and the borrower if the numbers had been much larger.

This is why lender liability is like a cat with nine lives. Many things can arise under the guise of this body of law and during difficult economic times, it is urgent to understand the pitfalls for you and your bank.

Earlier this year ABABJ.com ran an interview with noted lender liability attorney Barry Cappell, the author of a definitive book on the subject. [Read the story now.](#)

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts [here](#). You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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