
WHERE WORKOUTS MEET LENDER LIABILITY

It's no accident that lender liability claims only come after a loan's in workout

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A reader of last week's blog on workout credits wrote to ask my view regarding the ideal length of renewal periods on commercial real estate credit. He explained that one of his directors had asked why he put a workout customer on a six-month note, rather than a year or longer.

This is a good question. There's more to it than meets the eye, both in terms of making it work, and avoiding unintended consequences.

How big is your team?

This question addresses the culture of the bank; the workload of individual officers; and the degree of supervision that a particular credit appropriately requires.

Overall, I urge all lenders to try to work smarter, and not just harder. Longer renewal periods result in a lower level of paper shuffling, but the trade-off is that there are fewer natural "look in" opportunities on a borrower's activities.

This is a good time to consider the depth of the bank's credit bench. The individual lender may not have to handle it all, and that makes a difference.

Many banks have decent-sized back offices where supervision of financial statements, exception reporting, and oversight of loan covenants can be lodged. Monitoring can include the provisions of loan agreements that provide for certain affirmative and negative covenants. A loan officer supported by a credit administration department can indeed logically look to longer renewal periods if someone else can monitor covenants.

Lender liability trap

But the tension between "long" and "short" is also where the possible exposure to lender liability can arise.

Most lenders want to keep a troubled borrower on a relatively short string, so performance can be more readily monitored and evaluated.

At the same time, lenders must avoid excessive involvement in borrowers' activities and thereby avoid the fact or the appearance of control or undue influence on day-to-day business.

Consider too that it's only in a workout mode that lender liability has any meaning or context. Consider the history of the concept.

The original lender liability case dating from the 1960s involved a banker that inappropriately injected himself into the management decision-making process of a troubled borrower.

The banker's "advice" was lousy and the customer sued-and won for damages caused by the banker's irresponsible interference.

Fifty years later, lender liability has come to mean the appearance or substance of a bank's acting improperly toward the borrower. This can take a variety of forms but the easiest ones to understand are coercion and arbitrariness.

A troubled borrower usually faces a diminished range of choices in the management of his business and will often feel, justifiably or not, that the bank is being too tough or unreasonable.

The banker understands that administering the letter of the loan documents is hardly a direct road to lender liability.

But having tolerated violations of loan agreements and then suddenly enforcing the agreement literally, after a pattern of perceived forbearance, can sometimes lead to the accusation of unfair and arbitrary behavior toward the borrower.

I personally have little sympathy for the borrower who finds himself unable or willing to pay and then tries to transfer responsibility for his predicament to the lender. This is an evasion of responsibility by the borrower and is intellectual dishonesty on its face. The borrower signed the note and related documents, got the money, and then things didn't go as originally envisioned.

That happens sometimes and discomforts both the borrower and the bank.

How does this become the fault of the banker?

Well, increasingly today the plaintiffs' bar tries to make it so.

The truth of the matter is that some bankers have acted coercively. Some bankers have acted in a manner that third parties have decided was unfair to the borrower.

This is a big subject and beyond the scope of our discussions here. Just be mindful that the lender must act reasonably and consistently with the loan documents and any other bona fide agreements, written or oral, with the borrower.

It's just common sense.

Though sometimes that's in short supply between the parties to a troubled loan transaction.

Remember that absent workout conditions, there is insufficient oxygen for a lender liability claim or assertion to exist. It's precisely in the frequently adversarial business dealings between the parties after a business deal goes sour that lender liability problems occur.

Lender liability's human roots

Lenders must manage their credits for the benefit of the bank (both shareholders and depositors). Borrowers are protecting or trying to salvage what may be their life's work. So the stakes are high on both sides of the desk. Supervision is not control. However, supervision turned into direct management involvement can be problematic.

Many of us don't handle confrontations very well, while others thrive on them. This is fertile territory for lender liability claims, given the extremes of either of these human tendencies:

Too little assertion of the bank's rights by a confrontation-averse lender makes an ultimately harsh confrontation more likely.

Too aggressive or belligerent a posture can be viewed as intimidating, particularly in the mindset of the borrower who likely perceives that his back is to the wall.

So, you are thinking, how does this relate to the reader's question of a long or short renewal period for a troubled borrower?

As I stated earlier, it gets down to the culture of the bank, the size of the bank's staff, and the individual workload of the lender. "Short" needs to afford close and effective monitoring, while "long" should be tempered with carefully crafted and monitored covenants that aren't violated without the bank's knowledge and opportunity to notify the borrower of an event of default.

This is a balancing act in the day-to-day sense.

We should strive to order our environments to make the administration of a loan a series of relatively mundane events and avoid the surprises and angst of negotiating difficult and complicated situations on the fly.

The more we can control our flow of information to suit how we do our business the less likely we'll be subject to overreactions or accusations of attempts to control the activities of the borrower.

None of this is easy. And it's the reason that, as I've said before, working out troubled credit is one of the most useful

experiences that successful lenders can have for long and productive careers.

- 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 free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.