LENDER LIABILITY: CAN YOU DO SOMETHING FOR TROUBLED BORROWERS BESIDES SHUT UP?

Yes, but don't forget who you work for

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Prior to the Farah Manufacturing v. State National Bank case in the 1960s, borrowers and commercial lenders had many conversations about business, and bankers freely gave their opinions when asked. The Farah case was about a bank that imposed its judgment on the borrower; the judgment was subsequently shown to have been faulty, and the bank was liable to the customer for damages that resulted.

This is considered the watershed event of the legal phenomenon called "lender liability." It has come a long way over 40 years and in some ways is unrecognizable today, compared to the relatively simple set of facts originally at issue.

The important thing to mention here is that for over a generation, the relationship between most borrowers and most lenders changed on the aggressive advice of counsel. Counsel became concerned that this would be a fashionable line of attack by disgruntled borrowers against banks. Lender liability litigation altered the borrower-banker relationship.

What you can say

One thing that commercial lenders can share with their borrowing customers is their business experience and advice, based, in some cases, on a lifetime of observation and direct experience.

This is invaluable to many borrowers and is historically one of the many value-added features of dealing directly with a commercial lender. This is in direct contrast to the "empty suit" business model employed by many large banks today. No more is there necessarily a direct connection between the borrower and a representative of the lender where "hands on" experience can be shared and assimilated.

The banker has become more salesman than teacher.

When the lawyers come in...

In some respects, the lawyers were right.

Bankers in problematic credit situations can occasionally overreact. They can appear to be insisting on certain actions that prefer the bank's interests to the detriment of the borrower's long-term business strategy.

But I remember the abundance of caution of many managements in the 1970s and 1980s in having their lending staffs offer anything smacking of advice, for fear of litigation.

We occasionally feel tyrannized by the lawyers, and in this litigious environment, we should not expect it to be any different. They are paid to keep us out of trouble, and if we follow their advice, the results are generally happier for us and our banks than if we don't.

When bankers dither with borrowers

In this troubled business environment of the last three or four years, I've seen a resurgence of caution by managements and their counsel in the realm of business advice. We have no business telling the customer what he must do, because if we do, then we are exposed to the consequences of that action.

The customers, on the other hand, faced with collection activity by their banks, are looking for ways to delay proceedings and to find some bargaining leverage. They sometimes find it, too, due to the occasional or perhaps inadvertent inconsistency of behaviors by the bankers themselves.

It is this inconsistency in a variety of ways that now forms the basis for a considerable amount of what is called lender-liability activity.

Some loan portfolios are riddled with exceptions of a material nature and procedures manuals sometimes give scant guidance or direction to the lending staff. Directors should be cautious, too, that they do not appear to arbitrarily interrupt established patterns of activity negotiated by the lenders in the administration of their account relationships.

I've said in this space before that a solid credit culture ultimately rests on the ability and will to enforce internal controls specifying how credit is extended and administered.

A cautious approach to navigating the hazards

Any situation where some defect in a borrowing relationship has become evident is a situation prone to possible legal jousting and activity. One logical response is for the bank to frequently assist the lending staff in understanding the prudent boundaries of lender discretion.

Unfortunately, this tends to result in a separation of the banker from the borrower just at the time that the borrower could most benefit from the advice and "friendly ear" of the lender. One way to minimize liability is the "knee jerk" reaction of the banker to "clam up," though an experienced lender is less likely to cross the line between advice and compulsion. Maturity and experience are not foolproof, so caution is always appropriate for any lender dealing with problem loan situations.

It's our responsibility to the bank to handle the account relationship in a way that preserves the bank's interests. We also have a responsibility to our customers to help them steer through difficult times, though it is always subordinate to the best interests of the bank.

Three points of advice

My advice to lenders in a heightened lender liability environment is threefold:

1. Pay attention to what the lawyers tell you. They are paid to be cautious and caution minimizes exposure to lawsuits, frivolous or otherwise.

2. Act consistently and in concert with established policies. If you choose to make an exception, document your reasons and be consistent in what you do from situation to situation.

3. Don't deprive the customer of what you know and think. The customer is entitled to the benefit of your experience. Just don't share it in the form of explicit direction or a mandate for certain actions.

We deal continuously with subjects that are not always clear and concise.

Ambiguity is often an integral component of lending money.

We have principles that are embodied in our loan policies and they should be followed in a way that produces a consistent and beneficial result for the bank and, ultimately, the borrower. My concern is that sometimes we overreact to our environments and withdraw our help and support from the customer in the wrong ways and the wrong times.

We have to be firm and represent the interests of our stockholders and depositors. But without loyal and financially sound customers, we really have nothing of long-term value.

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 has been 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.

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