
ACTING SMART ON LENDER LIABILITY

Courts--official and of public opinion--increasingly use "fairness" as key measure

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For bankers, the risk of lender liability assertions rises at times of economic difficulty, as some borrowers seek to avoid responsibility for their obligations, or at least attempt to negotiate a softer landing in collection matters. In the last few months, I've had a series of experiences that have helped me more clearly understand what we face as lenders and how we can lower our exposures to unsatisfactory outcomes in lender liability suits.

Understanding the lay of the land

First, let's acknowledge that many of our institutions in the early 21st century have come under extraordinary stress. Public confidence and trust in some of our leading institutions has been eroded or undermined. From bankers, to diocesan bishops, to members of Congress, public confidence has been shaken in institutions previously richly endowed with public trust and esteem. It will take a long time to recover the lost ground and there are no quick fixes.

Ask any experienced litigator and he or she will tell you that the judiciary is becoming increasingly diverse by gender and by attitudes on social issues. As younger people begin to populate the judicial ranks, they bring views on societal issues that are possibly quite different from those held by members closer to retirement. This isn't necessarily good or bad. But it does indicate that change is occurring and that we are likely to see the effects of these changes in judicial attitudes and outcomes.

The law is the law, of course. But, increasingly, judges seem to be emphasizing "fairness." We all expect fair and impartial outcomes in our judicial process. But how one defines what is fair is an evolving process. I can't say this from firsthand experience but some lawyers I've worked with in the last couple of years are sensing a shift in emphasis: Fairness is now a pursued outcome rather than simply a derived outcome.

Note too how fairness, particularly economic fairness, is occupying a major role in our political discourse this election year. And it's increasingly possible that outcomes by the logical application of existing law and precedent may reach conclusions and outcomes that are deemed by some to be "unfair."

Viewing lender liability through a fairness lens

As this relates to lender liability, I have come to appreciate two important legal principles that can and should inform our behavior as lenders:

1. What constitutes "coercion or compulsion"?

2. What constitutes "good faith and fair dealing?"

Compulsion in the lender liability sense is the unilateral introduction of terms and conditions favorable to the bank's side of the business contract.

Are we forcing a borrower to commit to do certain things that he is otherwise unwilling to do? This is a hard question to anticipate. In a workout situation, the borrower and his business is in at least some degree of financial distress. This often results in new and restrictive borrowing terms by the bank and possible foreclosure activity on collateral. The borrower

may face potential ruin and he can hardly be expected to adjust to this altered set of circumstances with calm or equanimity. Nor should we expect him to. So we must be sensitive to how we approach our negotiations.

In the matter of good faith and fair dealing, this is a logical consequence of anticipated behavior by both lender and borrower as set forth in the lending contract. These are the contractual terms of the collective documentation--note, security agreement, mortgage, and loan agreement. We assume at closing that the borrower is going to honor the terms of the contract and he has the same right to expect that of us. These are reciprocal responsibilities.

In the good faith and fair dealing principle there is an "implied" covenant which is generally understood to mean that the lender should make all reasonable efforts to make the deal work. Just because the letter of the contract terms was met doesn't necessarily discharge the obligation to deal with the borrower fairly and in good faith.

To lenders, it means that we should walk the extra mile and be prepared to negotiate workout arrangements where we can if there is a reasonable hope for success and a measurably better outcome likely for both parties.

Any experienced lender can immediately see how the devil is in the details. What is "compulsion" in the context of a series of borrower-lender interactions? What is good faith and fair dealing in the pattern of daily activity between the parties?

This gets back to the principle of what is fair. And it also is circumscribed by the judgments and value systems of the participants.

Taking it to the real world

The most important advice I can share with lenders who are dealing with customers in workout contexts is to apply a very expansive definition of what fair means. So often we have institutional ideas of what the language in our loan documents means. Many experienced lenders will say of their paperwork that "We've always viewed it this way" or "Our document language has worked for us for years."

Here's the point: Bankers can appear arbitrary and unfair in how we approach the application of any of the contractual terms of default, but particularly non-payment defaults.

To avoid this, mind your behavior. Keep your personal reactions or pique from clouding your judgment or permitting you to appear petty or mean spirited. Go the extra distance to be reasonable. Failure to do as much can lead to a conclusion that you are behaving unfairly. If the contract gives the borrower five days to cure a default but the allowance of more time, say a month, makes no discernable difference to the risk profile of the bank, then at least consider allowing the longer cure period.

Be very careful in how you negotiate terms and conditions of a workout. What kind of a paper trail by emails or file notations are you leaving behind that might undermine someone's judgment of how you have behaved? (We talked about this two weeks ago.)

Be correct and yes, even in the face of provocation, be generous to the extent you can be, while protecting the best interests of the bank.

Go forward in fairness--you'll be judged by it

Many of today's lender liability suits are without merit--except to the degree that we contribute to the borrower's distress by being unreasonable or unfair.

The ultimate determination of what is fair is not within our purview. It will be made by judges and juries who increasingly are motivated by a sense of shared societal expectations. These are changing and they are probably changing faster than our institutional attitudes.

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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