

Lender Liability Morphs Into A New Worry For Bank Lenders

It's been many years since the term "lender liability" became an urgent topic among bankers. But now it rears its head again.

In its original form, "lender liability" meant that a bank could be held liable for certain actions that were imposed upon a borrower by a lender in the course of a lending relationship. If such actions imposed by the lender resulted in harm or financial loss to the borrower, the bank could be held liable. The principal casualty of a key lender liability lawsuit of the 1960s was the sharing of practical business advice by the banker to the borrower. This was based on bank legal counsel's concerns that the bank could be liable for inappropriate or ill founded advice.

Lender liability came up again in a different guise a few years ago. Under this later version, a bank could be held liable for damages incurred by the customer if the bank's agent arbitrarily behaved contrary to recent practice.

For example, suppose a customer was chronically in violation of one or more negative covenants in a loan agreement; however, those covenants had either never been enforced or were formally waived. If the lender chose to suddenly create an "event of default" and this in turn created negative consequences for the borrower, say with other creditors, then the bank could be held liable for the negative consequences of suddenly enforcing what had been essentially ignored. This could also extend to customers who are chronically overdrawn where the lender has permitted the continuance of overdrafts, or frequent overdrafts. Lawyers refer to this as "constructive forbearance." A sudden and apparently arbitrary change in past practices (where the bank was deemed to have extended its forbearance) could trigger liability to the bank for the consequences of damages suffered by the borrower.

Today's financial malaise has exposed many, if not most, banks to a significantly higher degree of liquidity risk. Under these conditions, lender liability should be "top of mind" to banks and bankers. Arbitrary changes to the way a lending relationship has been conducted can place the bank in jeopardy of a lender liability type law suit. It's not necessarily so that such law suits will be meritorious. But the risk is real because of anecdotal evidence that the very survival of many credit-dependent businesses is at stake.

- * How significant does this newer form of lender liability appear to be to your bank?
- * What measures have you been taking to prevent such trouble?
- * What are you hearing about this in your market, outside of your own institution?

About Ed O'Leary:

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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. O'Leary's website can be found at www.etoleary.com.