Lender Liability:

Nature, Extent, and Economic Impact of Agriculturally Related Claims in North Dakota

Summary Report

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This report determines the extent of lender liability claims among commercial banks in North Dakota, identifies characteristics of borrowers who raise such claims, and examines changes banks have undertaken in response to these claims.

When borrowers raise claims of lender liability and become delinquent, revenue of the financial institution declines. However, increased claims also affect expenses of the institution. The uncertainty of future negotiated settlements and awards may cause equity holders to demand higher risk premiums on their investment. Likewise, the potential of a large award may cause depositors concerned with bank liquidity to seek safer investment alternatives. To offset fund withdrawals, lenders raise rates of return on deposits which leads to higher costs of funds. As a result, the institution's weighted average cost of capital increases.

Variable expenses rise due to increasing amounts of staff time dedicated to working with legal counsel and the opportunity cost associated with larger reserves that must be set-aside to meet liquidity and risk needs. Fixed costs climb as a result of higher premiums for directors' liability insurance. Even though the bank is not directly responsible for payment of insurance premiums, such costs may be passed on to the lender in the form of additional perks so that existing directors may be retained or as search costs to find replacement directors increase. Loan volume declines as previously satisfied borrowers decide to patronize other lenders. Reasons for leaving may include perceived changes in bank policy, expectations of unfavorable treatment, and/or abrupt discontinuation of existing credit lines.

Considering all of the individual factors affecting bank revenue and expenses, it is hypothesized that the overall financial impact of rising lender liability claims is lower bank profitability. To test this hypothesis and quantify the magnitude of the impact, a survey of commercial bankers in North Dakota was conducted.

Survey Data

Data to estimate the extent and nature of lender liability claims was obtained from a survey of commercial banks in North Dakota. The surveys were distributed July 1988 to all 172 federal, state, and independently charted commercial banks in the state. Commercial banks held approximately 11 percent and 41 percent of the outstanding real estate and nonreal estate debt extended to North Dakota farmers in 1987.

Results

Usable surveys were obtained from 110 institutions, a response rate of 64 percent. Total agricultural loan volume reported by these banks was $829.2 million which represents 85 percent of all agricultural debt held by commercial banks in the state.

Of the 110 respondents, 24 reported that they had previously been, were currently in, or expected to be involved in a legal case of agriculturally-related lender liability. Given the

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fact that most institutions experiencing lender liability were involved in more than one case, 16 respondents reported that they were presently involved in a case, 17 had been involved in a case that concluded during the previous 12 months (as a result of borrower withdrawal, negotiated settlement, or judicial decision), and 11 expected to be involved in additional cases during the next 12 months. The geographic locations of the cases were not statistically related across North Dakota.

The various bases of lender liability raised by borrowers are summarized in Table 1. Again, a single case may involve more than one claim or basis for action. By far, the two most frequently raised claims were (1) displayed lack of good faith and fair dealing (e.g., failed to advance funds under a loan agreement without due notice) and (2) showed fraud, duress, and interference with the debtor's business affairs (e.g., threatened to declare a loan in default when the bank had made no decision or did not plan to call the loan).

These claims were raised against the loan officer involved in 8 instances and against the financial institution in 27 instances. There was only 1 reported case of lender liability against an officer or director of a bank.

Compensatory and punitive damages sought by borrowers averaged $595,250 and $3,040,000, respectively. These amounts are far greater than actual damages on cases that concluded in the past 12 months which averaged $10,000 and $16,000, respectively.

Claims that were not mentioned by the bankers included (1) encouraged borrower to purchase assets which the bank had an interest in (conflict of interest) and (2) failed to reveal a conflict of interest.

Table 1. Claims of Lender Liability

Survey Questions	Cases Concluded During Past 12 Months	Present Cases	Expected Cases During Next 12 Months	Total
Exercised control over debtor's business (includes taking over management, installing an agent to manage affairs, promising payments to other creditors on behalf of borrower)	1	4	0	5
Displayed lack of good faith and fair dealing (e.g., failed to advance funds under a loan agreement without due notice)	6	9	2	17
Improperly accelerated or foreclosed on a loan (includes not providing notice of change in lender-borrower relationship)	0	3	0	3
Showed fraud, duress, and interference with the debtor's business affairs (e.g., threatened to declare a loan in default when bank had made no decision or did not plan to call the loan)	1	9	1	11
Failed to provide full information to a debtor with a material question	0	1	0	1
Displayed negligent processing of loan applications	0	1	2	3
Failed to negotiate in good faith under a loan agreement	1	4	0	5
Overcharged interest	0	0	1	1
Encouraged borrower to purchase assets which bank had an interest in (conflict of interest)	0	0	0	0
Did not provide necessary expertise to a debtor	1	1	1	3
Interfered with the debtor's relation with another party	0	1	3	4
Improperly applied debtor's assets to reduce debtor's obligation to your institution	1	1	0	2
Failed to reveal a conflict of interest	0	0	0	0
Other bases	6	6	0	12

Characteristics of borrowers who raised the claims were elicited from the respondents. On average, those borrowers were 47.6 years of age and had .56 years of education beyond high school. Farms operated by the borrowers were not significantly different in size than the state average. Borrowers raising claims had been customers of the bank for an average of 12.4 years. Based on the judgment of the bank, 89.5 percent of the borrowers were in financial trouble. Of those in trouble, 44 percent have had their loans restructured at an earlier date.

The 110 survey respondents indicate lender liability has increased their cost of doing business and reduced the amount of credit available to farm borrowers. In response to either actual or feared claims in the future, bankers have increased interest rates an average of 8.7 basis points. On the total agricultural loan volume held by commercial banks in North Dakota of $974 million, farmers patronizing banks in the state are incurring $847,380 of additional interest charges annually as a direct result of lender liability. The quantity of loanable funds available to farmers has been reduced an average of 4.56 percent.

Even though only one claim of lender liability was raised against an officer or director of a commercial bank, they too are affected economically. A total of five officers have left their position as a result of too costly liability insurance or unavailability. Another 18 have dropped their liability insurance because of costly premiums.

To guard against future lender liability claims, 59.1 percent of the commercial banks purchase insurance with an average policy value of $6.242 million. Interestingly, insurance lowers a lender's cost of doing business by 7.37 basis points and each claim of lender liability raised the cost of operating by 8.66 basis points. Basis points represent the increased cost of doing business as a function of the number of lender liability claims and the purchase of insurance.

Moreover, lenders are undertaking a number of strategic actions to reduce the likelihood of future claims as shown in Table 2. Paramount is better documentation of a borrower's performance and communication with the borrower. Obtaining additional training and education on the fiduciary duties of loan officers and officers of a bank were also viewed as important.

Summary

This study has examined the extent and nature of agriculturally-related lender liability claims affecting commercial banks in North Dakota. Twenty-two percent of the banks surveyed stated they are involved in at least one case of lender liability. Failure to advance funds under a loan agreement without due notice and interference with a borrower's business were the most frequently cited claims. In response to actual or feared claims of lender liability, commercial banks in this survey have increased interest rates on farm loans and reduced credit availability. In addition, lenders have purchased formal insurance and improved loan documentation in an effort to reduce the likelihood of future claims.

Table 2. Lender Actions Undertaken to Reduce Likelihood of Future Claims

Action	Frequency of Response
Better documentation	25
Additional training and education	14
Use attorneys more	12
Attend lender liability seminars	10
Increased communication with customers	10
Tighten lending criteria	8
Don't make production or management decisions for borrowers	5
Change bank policies	5
Develop consistent loan terms and policies	3
Additional monitoring of borrowers	3
Honor existing commitments	3
Other	13