LENDER LIABILITY

In recent years, lender liability has dealt heavy, financial blows to numerous banks throughout the country. Even institutions not directly affected are concerned, and rightly so, by the onslaught of lawsuits imposed by customers. As a result, most lenders are in the unfortunate position of simultaneously looking for ways to protect themselves against liability while trying to provide quality credit to their customers.

The journal has attempted to address the issue of liability—some causes, results and possible preventive steps—in the following series of articles. In each one, the author provides some valuable insight to lender liability based not only upon case histories, but most importantly, personal experience.

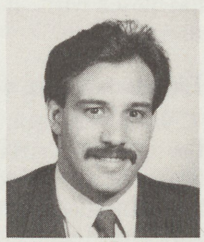
An overview

by Thomas J. Greco

Multi-million dollar damage awards recently obtained by borrowers in suits against their banks are focusing attention on an emerging legal theory known as lender liability. Ag lenders, particularly those in California, have been hard hit especially with juries assessing damages in the tens of millions of dollars. While these awards may ultimately be reduced or overturned on appeal, they serve to call attention to the seriousness of the present problem.

Lender-liability suits are not confined to the ag loan setting, and the underlying claims such as fraud, breach of good faith and breach of fiduciary duty are being applied in a wide variety of borrower-lender transactions. This article briefly examines some of the major cases in this area and notes some suggested approaches to prevent these lawsuits.

Recent trends



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Several of the legal theories used in lender-liability cases have been around for years. However, it generally is acknowledged that the recent trend of substantial damage awards against lenders can be traced to a 1984 decision by the Texas Court of Appeals affirming an $18 million damage award against the bank in *State National Bank of El Paso vs. Farah Manufacturing Company*. In that case the borrower, a clothing manufacturer, charged that the lender had abused a management change clause in the loan agreement by installing management which, the company claimed, caused it harm.

Another approach used often by borrowers is illustrated by a 1985 decision by the United States Court of Appeals for the Sixth Circuit. The case, *K.M.C. Co. vs. Irving Trust Co.*, involved a lender which refused to continue financing under a line of credit even though the requested extension was within agreed-upon limits and sufficiently collateralized. In affirming a $7.5 million jury award, the court ruled that the bank's power to refuse the extension (and demand repayment of the loan) was limited by the bank's duty to act in good faith. In this case the bank's downfall was its failure to give the borrower adequate notice that no further extensions of credit would be made.

In *Jewell vs. Bank of America (1986)* a jury awarded an apple grower in California $37 million, which eventually was reduced by the trial judge to $22 million. The borrower had alleged that the bank had abused a "relationship of trust and confidence" when, among other things, it agreed to provide long-term financing in exchange for additional collateral and then foreclosed without lending the additional sums.

Determining the causes

What lies behind the increasing number of lawsuits claiming lender liability? Some factors include the difficult times faced by such sectors of the economy as agriculture and energy. This is coupled with a general move in society toward more litigation as persons increasingly rely on lawsuits to assert their rights. Another cause which has been suggested is the trend toward larger banks through mergers and consolidations. Borrowers may be more inclined to sue their lenders when the loan relationship becomes less personal and more corporate.

As a result, banks must protect themselves from this onslaught of litigation. First, loan officers should be made aware of this problem and the potential damages associated with it. Many of the suits seem to arise from inconsistent application of loan policies or poor communication between the lender and borrower. Banks may want to review their activities in these areas. Another factor juries focus on is the treatment of the borrower by the lender—lenders should avoid any appearance of abusive behavior; and memos to the loan file should be clear, to the point and free of any sign of personality problems between the borrower and the loan officer. Finally, the lender and its attorneys may wish to review their loan documents to address the problem. For example, several banks in California are contemplating the insertion of a binding arbitration clause in their loan agreements in an effort to remove such suits from trial-court juries and place them before an arbitration panel of experts.

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