The end of the beginning in Iowa

by Thomas E. Salsbery

The possibility of large awards based on various legal concepts of lender liability is no longer a spectre for Iowa lenders—it's reality. Because lawsuits against lenders often are commenced by farmers as a desperate attempt to avoid loss of the farming operation, many lenders believe that a better agricultural economy and the enaction of farmer protections such as mandatory mediation, mortgage foreclosure moratoriums, homestead protection and Chapter 12 bankruptcy will reduce the possibility of being sued.

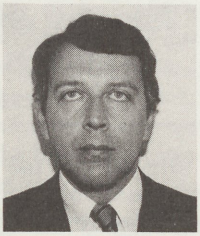
A serious concern

However, it is likely that lender liability will remain a serious concern to lenders for the following reasons:

1. With few exceptions, suits against lenders are based on traditional legal concepts and thus, attorneys are not forced to learn new areas of law before commencing lawsuits against lenders;

2. Because there have been successful cases against lenders, good lawyers retained by borrowers will always scrutinize bank forms and procedures for possible legal action against the lender;

3. Banks are defendants fully capable of paying damages if liability is established and thus, it is more likely that lawyers will accept contingency-fee arrangements in actions against banks;



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4. Juries generally view the farmer as the little person battling an impersonal institution and are more inclined to award higher damages.

The role of juries

Concerning the role of juries in the area of lender liability, my experience has been that if lender liability is established, the jury usually awards damages far in excess of damages proved at trial or sustainable on appeal.

The recent Iowa case of *Klooster vs. North Iowa State Bank, 404 N.W.2d 564 (Iowa 1987)*, certainly illustrates this problem. In that case, plaintiffs brought an action against the bank for actual and punitive damages on theories of wrongful attachment; abuse of process; conversion; sale of collateral in other than a reasonably commercial manner; tortious interference with business operations; and civil rights violations under 42 U.S.C. §1983. The jury awarded $1.1 of actual damages and $280,000 of punitive damages for a total of $1.380 million.

The trial court, apparently believing that certain separate jury verdicts were duplicative, reduced the award to $610,000 for actual damages and $100,000 for punitive damages. The trial court also awarded the plaintiffs $116,820 for attorneys' fees, making the bank's total liability $826,820. The Iowa Supreme Court in its decision further reduced the liability of the bank to $145,000 in actual damages and $100,000 in punitive damages, for a total of $265,000.

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My law firm has represented lenders in two cases where juries have awarded very high damages which subsequently were reduced. In one case, a jury verdict of $3.5 million was set aside by the trial court and reinstated by the 8th U.S. Circuit Court of Appeals in the amount of only $200,000. In the other case, the jury returned a verdict of $1.6 million. A new trial was granted, and the verdict in the second trial was approximately $600,000. In only one lender case have we obtained a jury verdict in favor of the lender.

Costly process

The lesson for lenders to learn from these examples is, if you decide to litigate rather than settle lender liability lawsuits, it may be a difficult, costly process and one where your bank receives very unfavorable publicity due to an excessive jury award. While the bank ultimately may win on appeal, it will in many cases require bank personnel to spend considerable time preparing for testimony at depositions and the trial, and the legal fees to the bank required for trial, post-trial motions and appeals can be extremely high.

It is good to keep in mind this observation attributed to Voltaire, "I was never ruined but twice; once when I lost a lawsuit and once when I won one."

Adapt to change

I believe that the long-term answers to protecting banks from potential liability are educating bankers about lender liability and changing bank practices on the basis of the experience of lenders in this area. It is important to understand that the rules of lending have changed and that many practices that bankers once viewed appropriate may now be viewed in courts as unreasonable or lacking in good faith. The following suggestions constitute some defensive measures that bankers may wish to consider:

1. Start a file where you keep articles about lender liability.
2. Have bank personnel attend conferences on this topic and encourage your legal counsel to attend legal-education programs on lender liability.
3. Conduct training seminars on this topic in the bank.
4. Re-examine basic documentation and procedures.

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Loan documentation should be reviewed for provisions which provide the bank with excessive control of the borrower's business, or for provisions that allow the bank to exercise rights that might be viewed as violating the concept of good faith.

For example, restrictive covenants that require the bank's permission prior to the borrower's action such as a prohibition against large capital expenditures are generally acceptable. But clauses that allow the bank to control the management of the company, or to control who manages the company should be avoided.

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I recommend that bankers base loan provisions on objective standards rather than on the discretion of the bank. For example, do not state that advances under a revolving line of credit will be made at the discretion of the bank, but rather that advances will be made unless the borrower is in default. The bank can define default very broadly. The amount of advances available to the borrower should be based on well-defined borrowing bases—not on the bank's discretion.

Many loan agreements contain various waivers of borrowers' rights, including a right to acceleration or notice of default. These provisions should not be exercised except in exigent circumstances. If an incident of default is not likely to be enforced, consider deleting it from the loan agreement.

When a loan is in default or is likely to become in default, make certain that the loan officer is competent in the area of loan workouts. Also, consider assigning a new loan officer to the file in order to obtain a new perspective on the loan. Avoid personality conflicts between bank personnel and the borrower. Juries respond very negatively to evidence that bank employees have acted with malice or arrogance toward a borrower.

State only the facts

Maintain meticulous documentation in the loan file. Document all decisions and conversations with the borrower concerning the loan in the loan file, and document all defaults, whether the default was waived and the conditions of the waiver. State only the facts of the loan in the file. Do not put any subjective comments or other recitations into the loan file that you would not wish read to a jury at trial.

In one of my cases, the loan comments were filled with derogatory comments about the debtor's intelligence, farming expertise and honesty. While it may have been the truth, it was dangerous to the lender's case because the borrower alleged that the lender's decisions were based on malice toward the borrower. On the other hand, comments or other documentation favorable to the position of the bank should be included in the loan file.

"Avoid personality conflicts between bank personnel and the borrower."

Avoid giving business advice to the borrower or representing yourself as an expert in the borrower's business area. A fiduciary relationship may be found if the borrower can show reliance on the advice of the bank and that the bank has in some manner taken advantage of the borrower.

If you have waived provisions in your loan agreement in the past, give the borrower prior written notice before enforcing such provisions in the future.

Do not misrepresent what the action of the bank will be if the default is not cured or other action requested by the bank is not taken.

If you decide to work out the loan, obtain a release from the debtor or representations by the debtor in the work-out agreement that there are no claims against the bank or defenses of the debtor to the bank's debt.

Utilize legal counsel in all aspects of dealing with lender liability—from reviewing procedures and forms, to workouts and decisions concerning enforcement. You probably will pay lower fees if you properly utilize your attorneys, than if you involve the attorney only after the debtor has brought suit against you.

In conclusion, if banks commit to implementing preventative measures including staff training, properly drafted loan documentation and appropriate use of legal counsel, it might be the beginning of the end of large damage awards in lender liability cases.

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