Texas Bank Wins Lawsuit Over FSA Loan Guarantee

by J. Peter Morrow

Robert Hobgood, president of First National Bank in Haskell, Texas, didn't take no for an answer. When the Farm Service Agency (FSA) rejected a loan guarantee for one of his customers, he appealed to the National Appeals Division and won. Then, when FSA refused to implement the hearing officer's decision, he sued them in federal court. The result was a stunning victory for guaranteed lenders and borrowers who seek direct and guaranteed loans from FSA.

In his decision in the bank's favor, Federal Judge Samuel R. Cummings, of Lubbock, Texas, blasted the FSA for "stonewalling" and declared its actions to be "arbitrary, capricious and not in accordance with the law." *(First National Bank v Glickman, Civil No. 5-97-CV-133-C)* He then took the extraordinary step of ordering that the guarantee be issued. FSA promptly did so.

This case started as a routine loan application for a typical FSA guaranteed borrower. There was nothing unusual, controversial or unapprovable about the loan, and certainly nothing to suggest it would wind up in federal court. The twists and turns of the FSA's denial, its refusal to implement the appeal decision, continued stonewalling and subsequent court decision offer important lessons for all guaranteed lenders and borrowers.

Background

First National Bank is a community bank in Haskell, a farming community 185 miles west of Dallas. Wheat and cattle are staples of the local economy.

In September 1995 the bank sought an FSA guarantee of a $400,000 loan to a cattle rancher to refinance a current operating debt and purchase

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additional cows and calves. The operating plan for the year included the sale of approximately $50,000 of wheat to be harvested in early 1996. Although the rancher had historically grazed his wheat out, he planned to harvest the 1995-96 crop because cattle prices were low and grain prices relatively high. With the combination of cattle and wheat income, the bank concurred that the borrower's plan was feasible and was based on sound business judgment. A complete application, including the proposed cash-flow plan, was submitted to FSA.

In October 1995 the FSA county office issued an "adverse action" denying the proposed guarantee, based on the fact that the borrower did not have a history of selling wheat. (FSA initially cited several other factors as reasons for denial but resolved or withdrew all of them prior to the hearing.) The Agency did not dispute the feasibility of the projected wheat yield or price, but it simply made an arbitrary decision that no wheat income could be included in the plan because the borrower's previous practice had been to graze the wheat. The FSA cited no statute or regulation to support the notion. It was, on its face, an arbitrary and silly reason to turn down a loan.

The bank appealed to the USDA's National Appeals Division (NAD). NAD is a USDA-wide appeals function with some 80 hearing officers stationed around the country. The specific purpose of NAD is to allow banks and borrowers who have been rejected by FSA to resolve the matter administratively and avoid expensive litigation. The hearing officer's job is to listen to the facts of the case, apply the relevant laws and regulations and reach a decision as to whether the Agency was correct in its denial. A hearing officer's decision may be appealed by the losing party to the NAD national director in Washington, D.C. After a final determination, FSA is required to "implement" the decision. Implement means that the Agency must take the actions specified by the hearing officer. If the Agency decision is reversed, it must reissue an amended decision as of the date of the original adverse action, with any changes required by the hearing officer. Implementation is not discretionary–it is required under the law.

First National Bank's hearing was held in April 1996. The only issue was the projected wheat sale income which FSA had disallowed. On May 3, 1996, the hearing officer issued his determination, completely reversing the Agency's decision to deny the guarantee. He made a specific Finding of Fact that the borrower's plan to harvest wheat was "a sound management decision" and that the amount of the income was fully supported. The FSA Washington Office refused to request further appeal, concluding that the hearing officer's determination regarding income from wheat was correct. However, Washington also instructed the Texas State FSA Office to "update" all financial information and to use a "revised" financial plan based on "current" information to implement the appeal decision.

FSA then proceeded to break the law in several important ways, as Judge Cummings ultimately found. First, it did not implement the decision within 30 days as required by regulations. The deadline for implementation was June 2, 1996, and FSA made no attempt whatsoever to meet it.

Despite repeated contacts by the bank in July, August, September and October, the Agency did nothing. Finally, on Dec. 3, 1996, the Texas State FSA Office wrote that it would allow the bank to submit a new cash flow and new appraisals – in effect, to reapply for the guarantee. Rejecting an application in October 1995, losing an appeal in May 1996, and then inviting the bank to reapply in December 1996 is what Judge Cummings later would refer to as FSA "stonewalling."

Second, the Agency violated its regulations in requiring that a new application be submitted. To implement an appeal decision, the Agency must merely correct the errors found by the hearing officer in its original decision, and not reopen the entire application for reconsideration. In this case, the judge ruled that all FSA should have done was put the correct wheat income back in the plan and issue the guarantee. The old FmHA had a procedure which required local offices to implement appeal decisions without changing anything except errors cited by the hearing officer. After its takeover of FmHA, FSA scrapped this procedure, even though the underlying rules have not changed. The Agency now routinely requires updated information and asserts the right to consider new facts and subsequent developments in rejecting applications. Often called the "revolving door," this policy has led to much frustration among both lenders and borrowers who are required to continually update or resubmit applications. It is illegal, according to Judge Cummings.

Third, in refusing to implement the hearing officer decision, the Texas State FSA Office's Dec. 3, 1996, letter reasserted several reasons for refusing the guarantee which had been resolved or withdrawn by the Agency prior to the hearing. In addition, the Agency asserted brand-new grounds for rejecting the application that had not been raised before. The judge found these actions to be arbitrary and capricious.

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The Lawsuit

By the time First National Bank received the Agency's December 1996 invitation to reapply, the borrower had completed the 1996 crop year. Lacking operating monies because of the FSA denial and delays, and after a serious drought in early 1996, the borrower's financial condition had deteriorated substantially. The bank had already charged off a portion of its direct loans and faced significant additional losses. Nevertheless, because it had prevailed in an NAD appeal hearing and believed FSA's decision was wrong, the bank had continued to service this distressed borrower. Feeling strongly that it was entitled to the guarantee, the bank sued FSA in federal court in Lubbock, Texas, on Aug. 10, 1997.

The bank argued in its complaint that for nearly a decade FSA and its predecessor FmHA had routinely ignored and refused to implement appeal decisions. It cited the Agency's

use of the "revolving door" to continually demand "revised" or "current" information. It argued that the Agency "stonewalled" the decision by never acting on it at all, and that the FSA's conduct violated the laws and regulations requiring it to implement appeal decisions. The bank asked the court to issue a judgment that the Agency's actions were unlawful and that the Agency be required to issue the guarantee as requested.

The court did just that. The decision is extraordinary in the language of criticism aimed at the Agency, and in the remedy it afforded. The court stated: "What the Agency did was essentially 'stonewall' the appeal determination, ignore the Agency's own previous withdrawal and waiver of all reasons for disapproval other than the harvested income reason, and found entirely 'new' additional reasons in 1996 to assert as a basis for denying a 1995 application. These actions are arbitrary, capricious, and not in accordance with the law." Judge Cummings further stated: "The Agency in this case simply did not like the outcome, and fashioned an extra-regulatory means of nullifying its effect." The court ruled that there was no reason to remand the matter back to the Agency because "the facts in this case were made abundantly clear by the hearing officer in his appeal determination and in the administrative record." The judge ordered the Agency to issue the guarantee.

Based on the decision, the bank will file a motion to recover its legal fees under the Equal Access to Justice Act. Counsel advises that because the government had no reasonable basis for the decision it made, the bank has an excellent case to recover its fees and expenses.

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Lessons

This decision was a significant victory for the bank, enabling it to recover funds previously charged off, advance needed operating monies to its borrower and keep a local farmer in business. Robert Hobgood knows the satisfaction of hanging in there with a customer when you know you are right, not taking no for an answer, and beating the government in court at its own game. But beyond First National Bank, there are lessons in this case for all guaranteed lenders and borrowers.

First, the system works. The FSA was flat wrong in its decision and wrong to stonewall the NAD determination. The federal judge saw the facts, applied the law and stuck it to the Agency. This decision is now of record to be cited by lenders and borrowers who face similar Agency stonewalling. Hopefully, this decision will be a warning to FSA officials to clean up their act.

Second, a wrong has been righted, but without full compensation. The real loser in this case has been the bank's customer. As Hobgood puts it, "The bank is out a bunch of effort and money and the government wasted taxpayer dollars in this fight, but it's my customer who really got hurt. He's gone almost three years without operating money and proper servicing

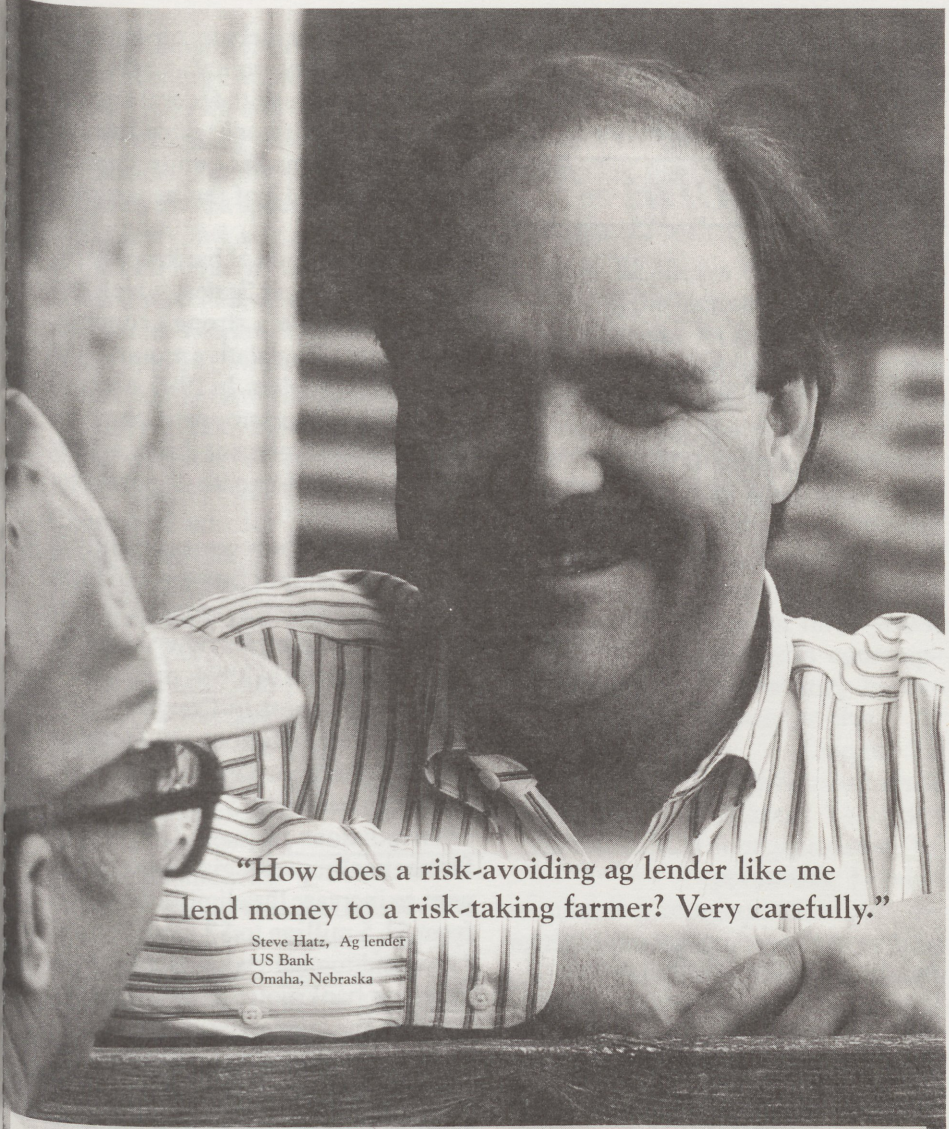
because of the wrongful denial and delays." As sweet as a court victory can be, it rarely fully compensates for the initial wrong.

Third, the case points out the extent to which FSA can try to assert control over even the tiniest detail of loan decisions under its guarantee program. The decision to deny the wheat income was arbitrary and senseless. Instead of correcting a bad decision, FSA state officials closed ranks and scrambled for other reasons to deny the guarantee. This petty second guessing of the bank's application, and the ensuing bureaucratic maneuvering, happens too often in the FSA guarantee program and causes many banks to stay away from it. Banks don't have these problems with the SBA, Eximbank and other federal government guarantee programs.

Fourth, the Agency's resistance to issuing this guarantee reflects its wariness of proposals from lenders to move their direct borrowers into the guarantee program. FSA has structured its guarantee program as sort of a "halfway house" between its direct lending and private bank credit. A borrower cannot get a direct loan if he can get a guaranteed loan, and he cannot get a guaranteed loan if he can get an unguaranteed one. FSA actively encourages borrowers to graduate from direct loans to guaranteed loans as part of a track to move them eventually to pure commercial credit. But in my experience, FSA does not always welcome borrowers moving from the other direction. It often believes that a bank applying to move a current borrower into the guarantee program is merely trying to bury its losses with FSA.

Finally, as a result of this concern, FSA may subject guarantee requests for previously unguaranteed borrowers to unusual scrutiny, and bankers should be careful in handling provisional credit to such customers while awaiting the outcome of the application process. If the guarantee is rejected, at best there will be a lengthy appeals and/or litigation process before the provisional exposure is covered.

Bankers know that customers sometimes hit bumps that are not fatal, but are serious enough to prevent continued bank exposure by regulatory standards. The FSA guarantee program can be an effective way to preserve customers and keep community farms in business. But if the guarantee is rejected, both the bank and the borrower could be exposed, and the banker will face Robert Hobgood's tough decision: to cut losses and put a client out of business or take on the government in court. jal



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