

## *Lender Liability News from the Front Lines*

# **Practice Prevailing Banking Standards to Avoid Lender Liability Risk<sup>1</sup>**

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Lender liability remains a key risk for all banks providing loan accommodation. Yes, it's true that our judicial system has, as a whole, become much less willing to favor the plaintiff over the past decade. In part, this unwillingness is due to the vast number of early 1990s credit crunch" cases where, for example, high-living borrowers, using commercial loan proceeds for extravagant personal expenditures, were claiming that the bank "failed to lend them enough money."

Nevertheless, this writer has provided expert testimony in approximately 30 cases since 1992 and provided expert services in twice as many legal conflicts that settled before the testimony phase. Therefore, my experience is "real time" and extremely current working on behalf of both bank litigators and, sometimes, for plaintiffs in matters where there was clear evidence that the lender "stepped over the line".

The "line" is based on prevailing conceptions about what constitutes prudent and reasonable banking standards. If the lender's acts of commission or omission represent prevailing banking practices (at the time the events occurred), then it is unlikely that the lender will be held liable. It is possible, however, for "sloppy" lenders to give the appearance of impropriety which, at a minimum, could lead to expensive litigation even though the ultimate judicial finding may be favorable to the bank.

Consequently, it is essential for bank lenders to be fully aware of prudent and prevailing banking standards not only for profitability and soundness, but also for specific defenses against the ever-present lender-liability risk. RMA remains the ultimate resource in assisting member banks in maintaining modern, effective and efficient credit practices. In fact, RMA publications

often become key exhibits as leading edge documentary evidence of prevailing and prudent banking conduct.

As discussed more fully in the September issue of *Lending & Risk Management News* ("Compliance Risk Must Be Handled Effectively" p. 3), you must play by the rules and comply with laws, regulations, accepted practice, policies, procedures, terms of loan approval and ongoing documentary rights.

Otherwise, there are many penalties that the lender must face. They are set forth in outline form below and include current examples of the most frequently occurring types of either actual or perceived deviation from the rules that have led to costly litigation. As evident below, I have used the lender liability caption in its broadest sense to include criminal charges against bank officers and directors as well as liability arising from the offering of other bank services.

### **Criminal Sanctions**

- Bank officer exceeding his or her authority for personal gain
- Bank officer failure to report visible criminal activities
- Senior bank officer failure to provide adequate policies and procedures relating to the detection and reporting of criminal activities
- Bank director loan approvals for personal gain

### **Direct Damages**

- Improper use or release of credit information

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- Intentionally misleading creditor(s)
- Willful intent to cause harm
- Careless release in bank promotional materials, loan sales, etc.

### **Course of Conduct**

- Misleading borrower as to willingness to enforce rights or remedies

### **Improper Notice**

- Terminating advances
- Filing judgments
- Taking possession

### **Control**

- Requiring specific borrower staffing
- Dictating specific managerial decision
- Otherwise acting as owner/manager

### **Discrimination**

- Selecting individuals or groups of borrowers
- Assisting one bank customer to the detriment of another

### **Diminution of Legal Right to Full Payment**

- Carelessly drafted letters and internal communications
- Failure to rely on financial information, documented rights or collateral items
- Poor policies, procedures and/or credit practice
  - Inability to collect from prime obligors
  - Inability to collect from guarantors
  - Inability to sue auditors, attorneys
- Conflicts involving bank investments, trust activities, personal activities of bank officers/directors
- Improper borrowing authorities

### **Other Service Risk**

- Violation of Reg J - check processing
- Violation of Reg CC - funds availability
- Improper deposit account authorities

These types of bank liability issues have occurred most recently within the scope of this writer's recent experiences. There are certainly numerous other challenging events and actions that may arise in the future given the fact that banks are senior secured lenders with all other credit constituencies reaping great benefit from any breach of the lender's fortifications.

Also it should be noted that acts categorized here in one section for simplicity also could cause indirect harm to the lender in another category.

Bear in mind that most banks, large and small, have upgraded their credit process significantly as a result of the early 1990s "credit crunch." Any bank still living in the past is now even more exposed to lender liability today owing to the general elevation of bank credit standards during the mid-1990s.

### **Conclusion**

Space and confidentiality prevent a more complete airing of these issues. It is important that your credit people are fully conversant in the areas outlined in this article and that bank policies and procedures address fully each and every potential liability facet.