The Standard of Care for a Workout Banker

By: Nancy Terrill, Managing Director, Inglewood Associates LLC

How many conversations have you participated in where the parties question the actions of a workout banker? Having worked as a workout banker for most of my career, I know that my former fellow bankers' actions are frequently impacted by banking regulations, influences behind the scenes at the bank, or the standard of care to which a workout lender must adhere.

Taking the issue to another level, I have been hired several times as an expert witness in lawsuits involving the workout lender's behavior and decisions usually associated with a business failure. These lawsuits often come from guarantors who want to avoid paying their obligations under the loan guarantee, or other creditors who want to get more funds from the liquidated estate.

Lenders assume that most lender liability claims would be situations where the lender called the default under the loan agreements and demanded payment too soon. In these cases the plaintiff would claim that the lender harmed the viability of the business' going concern value. However, many lawsuits claim that the bank actually took aggressive loan collection actions <u>too late</u>. These cases frequently involve fraud where the real evil-doer was the business management who was untruthful or improperly withdrew funds from the company when he or she realized that the business was going to fail. Then, in these cases, the banker gets sued for not knowing the truth (which was deliberately hidden) and not taking action to collect the loan sooner.

One question which is often present in lender liability lawsuits involves the lender's action or lack of action in the face of a default under the loan. Each case can vary depending on the exact wording of the loan documents, and the loan situation. If the lender takes action, it can simply be to request compliance with financial or collateral information requests so the lender can better determine the situation. If the loan is monitored under a borrowing base, the lender may suspend new advances until the loan is back in compliance with the collateral borrowing base. If the lender declares a formal event of default, they may continue to lend under a forbearance agreement that usually requires defined behavior or action by the borrower within a specified time. The lender may choose to increase the interest rates or charge a fee for the default. Finally, the lender may accelerate the loan and demand payment of the entire loan. Loan acceleration is usually followed up with immediate legal collection activity.

Engaging an expert witness or turnaround consultant with a depth of experience in working out troubled loans will put you in the best position to determine the proper action the lender should have taken and when. Parties in these lawsuits who do not have practical workout experience often erroneously assume that the lender should have had complete control over the borrower or collateral. Bankers usually do not have that control. For example, a lender may hold the car titles of an automotive dealership as a frequently used method to closely monitor the dealership's car sales. However, even this approach does not stop the dealer from selling the car, keeping the funds and fraudulently seeking a replacement title for the new automobile owner. In this situation, this is not incompetence on the part of the lender, but it is an example of fraud on the part of the unscrupulous borrower by outmaneuvering the customary standard of care of the lender.

Knowledge of the inner workings of a bank in a workout situation can greatly assist getting the right decision in these lawsuits. One such example was a plaintiff's claim of wrong doing when a workout banker put collateral proceeds into a bank controlled depository account rather than immediately applying the funds against the loan. The plaintiff in the case ascribed some evil doing to this action, while the much less nefarious answer was that workout bankers frequently do this to keep funds accessible until all of the expenses associated with the case are paid (such as rent, security, sales commissions…). If the lender applied the funds immediately to the loan which is flagged as non-performing, the lender would have had a great deal of difficulty processing future advances on the loan to cover those required expenses.

Often parties in lender liability lawsuits hire ivory tower expert witnesses who are experts in banking regulations but have never actually worked out a bad loan. These witnesses often focus on new loan advances to a financially challenged or insolvent workout borrower as a bad lending practice for the bank. The inexperienced expert will often cite OCC underwriting guidelines as their authority. This is very case specific, but in most cases the inexperienced expert's focus on new advances is not relevant. The relevant question should be the new advances *net of loan pay downs* to calculate the dynamic total loan exposure which is then compared to the true collateral value. Using this formula, the workout lender calculates their likely and worst case loss on the loan. Using that formula over time, the lender's focus is to avoid growing or actually decreasing the expected loss on the loan. While loan advances are part of the calculation, a lawsuit focused on only that one part of the formula misses the focus of the workout lender which is to decrease the potential loss from the loan.

Another frequent fact pattern in lawsuits generated from a troubled loan is that the lender's estimated loan loss increased over time. An experienced expert knows that this can be caused by either 1) the decrease in collateral assets (i.e., assets physically disappeared or cash collections from receivables were not used to repay debt), or 2) the decrease in the collateral value was a function of better information about the value of the underlying collateral such as from an inventory count or outside appraisal. The experienced expert knows that the disappearance of physical assets might have been stopped with earlier action by the bank while the decline in value based on better knowledge is not something that would likely have changed based on the timing of the lender's actions. Note then that the experienced expert's opinion simply identifies the standard of care of a workout lender, and may support positions taken by either the plaintiff or the lender in a lender liability lawsuit, depending on the facts.

In conclusion, while the logic of a workout lender's actions or inaction may not be apparent to non-bankers, they may be in fact following normal workout standard of care behavior based on banking regulation and internal process and procedures. Engaging an individual or firm that has hands-on experience in bank workout practices will help you understand those influences or, in a post mortem environment, can identify where true lender liability may exist and refute the irrelevant points in the litigation. This provides focus on the relevant facts of the case to allow the court to reach the proper decisions.