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The Negative Effects of Lender Liability

In a number of recent legal decisions, courts have awarded large damages to borrowers who sued their lenders for allegedly breaching the terms of credit agreements. These lender liability lawsuits have become an area of concern for lenders at least partly because of the significant damages awarded in some cases. This issue is interesting to economists as well because lender liability may have significant economic consequences for lending markets.

This *Letter* argues that lender liability limits the scope for a lender to exercise control over a borrower. If lenders fear a lender liability lawsuit, they may be reluctant to enforce loan covenants or use discretion under credit agreements. As a result, they may alter their criteria for making credit decisions. For example, lenders may choose to avoid loans where exercising control is likely to be important. Or, they may increase loan rates in order to be compensated for the loss of control. This means that some firms may not be able to borrow under the more expensive terms, and that some profitable investment opportunities may have to be abandoned. There appear to be no economic benefits from lender liability to counterbalance these negative effects.

Moral hazard in loan markets

When an investor does not manage the firm in which he invests, a "moral hazard" problem can arise: management may engage in certain actions at the expense of the investor. To reduce this problem, the investor uses a variety of financial instruments, although, in the case of banks, the set of potential instruments is restricted greatly by various statutes; bank assets are effectively limited to debt instruments.

In writing loan agreements, lenders typically include certain requirements, or covenants, that borrowers must satisfy. These loan covenants provide banks with (limited) means to control moral hazard problems once they are detected. In general, covenants are written so that if the lender detects management engaging in actions detrimental to its interests, the lender can call the loan or otherwise declare the borrower in default. Because of this threat, management will be reluctant to engage in those actions. To help detect moral hazard problems, lenders usually monitor borrowers' behavior to protect their interests, and sometimes require borrowers to disclose information about their activities.

What is lender liability?

Lender liability has to do with how a loan agreement is enforced by the courts. The terms of a loan agreement characterize the relationship between the borrower and the lender. These terms typically include the interest rate on the loan, the repayment schedule, and any additional covenants describing activities the borrower may or may not engage in during the life of the agreement.

A lender liability lawsuit arises when a borrower claims that the lender acted improperly under the explicit terms of the loan agreement or under the terms implied by contract law. The terms implied by contract law are especially important, since many suits allege breaches of implied—rather than explicit—terms, such as "good faith" or "fiduciary responsibility."

An example of a lender liability lawsuit that alleged improper explicit loan terms involved a clothing manufacturer that sued its bank. One covenant in the loan agreement stipulated that if particular individuals were hired to manage the company, the bank would consider this a breach of contract and call the loan. The bank apparently felt that these individuals would be likely to act in a manner contrary to the bank's best interests. The company subsequently brought in the managers in question and then sued the bank (and won) on the grounds that the loan covenants illegally restricted the operations of the firm and thereby cost it several million dollars.

Treatment in the courts

The emphasis on implied terms in loan agreements has given courts wide latitude in determining lender liability, and created a high degree of uncertainty for lenders about the enforceability of their contracts. For example, in one case, a

lender was held not to have acted in good faith because it failed to provide the borrower with advance notice that more credit would not be forthcoming under a line of credit agreement. In another case, a borrower sued its lenders because they had warned the borrower that certain actions it was contemplating would represent default under a covenant of the loan. As Fischel (1989) points out, putting the two cases together creates a Catch-22 for lenders: advance notification is simultaneously required and penalized.

A similar lack of consistency pervades the damage phase of lender liability cases. Under the law, actual damages serve as compensation only for unavoidable injury. Thus, if the lender breaches, a borrower may collect for the cost of finding alternative financing, but not for lost profits if alternative financing was available. Yet, in one case, a borrower collected $105 million for alleged lost profits due to a lender's refusal to lend $3 million. The court's opinion implies that the borrower would not have been able to borrow elsewhere, despite the allegation that the project was highly profitable.

The precedents set by these lender liability cases call into question not only the rights of lenders to exercise discretion in applying loan covenants, but also a lender's legal authority to enforce restrictive loan covenants at all. In the extreme, it is conceivable that loan agreements could be reduced simply to setting an amount to be lent, the appropriate collateral, an interest rate, and a repayment schedule. The effective consequence, then, of present lender liability case law is to require that all loan agreements belong to a restricted set of contracts in which only very specific, and limited, covenants are permitted. Any agreement outside this set will not be enforced as written.

Economic theory suggests that such restrictions will reduce the efficiency of financial intermediation; that is, funds may not flow to their most economically productive uses. If borrowers voluntarily sign contracts from outside the restricted set, they do so because such contracts are preferable to contracts from within the restricted set. Requiring them to choose from the restricted set thus would seem to make them worse off. However, there may be a few situations in which restrictions on contracts can enhance efficiency.

Justifications for lender liability

One potential rationale for restrictions, offered by Fischel, is that some lender liability is necessary to prevent lender misbehavior. Indeed, it is easy to conceive of lender misbehavior; a recurring theme in early melodramas involved the wicked banker threatening to foreclose on the family farm unless the heroine acquiesced to his advances. In a business context, a lender conceivably could attempt to extract additional concessions from the borrower with the threat of enforcement of the loan contract.

But in practical modern settings, two important controls exist to limit such misbehavior. First, misbehavior anticipated by the borrower is best handled in the loan agreement itself. If the borrower is worried about the lender invoking a covenant capriciously or unfairly, then the borrower should insist that the loan agreement clearly specify the terms under which the loan can be called (or other features enforced). If the borrower is still worried, then the borrower should insist on clauses restricting the lender's actions. For example, the agreement can specify particular commercial penalties that will be imposed upon the lender if capricious actions are taken. In short, just as the lender attempts to prevent misbehavior by the borrower through various covenants, the borrower can use the same method to prevent misbehavior by the lender.

A second constraint on lenders protects the borrower even from unanticipated actions of the lender: competition from other lenders. In a competitive capital market, a lending institution that develops a reputation for capricious behavior will find itself at a competitive disadvantage—borrowers will go to other institutions.

Indeed, economists believe that the relationship between a lender and its borrowers is what justifies the existence of the banking sector in the first place. Relationships with borrowers are carefully cultivated, costly to develop, and difficult to replace. To intermediate credit to bank borrowers safely, a bank must expend resources developing the ability to monitor the creditworthiness of its loan clients. These monitoring relationships have mutual value to borrowers and lenders, and capricious action by the lender threatens this major source of the value of a bank.

Another rationale for restricting loan agreements is that the private actions of the borrower and lender may injure some third party whose interests were not represented in the loan negotiations. For instance, some other creditor's claim on the borrower's collateral may be diluted by the new loan. Such an "externality" is, however, easily (and commonly) dealt with by the covenants that this other creditor puts in his agreement with the borrower.

Asymmetric information and loan covenants

A third argument for restricted contracts argues that restrictions may be beneficial when the parties to the contract are asymmetrically informed; that is, when one of the parties has the advantage of superior information about the facts relevant to the loan contract. Loan agreements are often negotiated in situations of asymmetric information; the borrower generally has better information than the lender about the risks underlying the transaction. Nevertheless, it is questionable whether the problems posed by information asymmetry in practice justify the restrictions implied by lender liability.

In an environment of asymmetric information, the terms of a contract play two roles. The first role is to fix the terms of the agreement (e.g., the amount to be lent, the interest rate, etc.). The second role is to transmit information (e.g., if the borrower refuses to offer collateral, you might reasonably infer that he views himself as likely to default on the loan). It is this second role that can lead to distortions from efficiency. Specifically, because of a desire to transmit favorable information, a party to a contract can feel compelled to ask for an inefficient contract. For example, to convince the lender that the risk of default is low, the borrower might offer too much collateral, putting himself in an overly risky position.

Asymmetric information may lead the parties to include different terms in the contract than they would have if the same information were available to all. Of course, many loan covenants likely would be included even under symmetric information. This is true for those covenants that are intended to prevent the borrower from engaging in certain behavior at the expense of the lender (e.g., undertaking excessively risky projects). However, some covenants may be a rational response to asymmetric information. For instance, an if-we-find-you-misrepresented-yourself-we-can-call-the-loan covenant would serve to ameliorate some of the problems created by asymmetric information.

Research by Hermalin and Katz (1991 and forthcoming) suggests that externalities and asymmetric information may be the only significant economic grounds for restricting the contracts rational agents can write. Absent those exceptions, we argue, the courts should not reinterpret the intent of written contracts. This is a strong conclusion, and one that is not universally accepted.

The negative consequences of lender liability

We have argued that lender liability effectively limits the use of loan covenants and lender discretion, and that banks will be less able to control moral hazard problems in loan markets. This reduced ability to control moral hazard will have two consequences. First, since loss of control is costly to a bank, it will require compensation in the form of higher interest rates. This, in turn, will lead to lower rates of investment by firms. Second, banks may not lend to enterprises where the moral hazard problem is potentially greatest (or, equivalently, these enterprises may be priced out of the bank-lending market). This represents a change in the allocation of credit, which may not be desirable. For instance, as argued in the June 1, 1990 *FRBSF Weekly Letter,* the moral hazard problem is particularly great with new ventures. Thus, a potential consequence of lender liability is that new ventures will find it even harder to obtain financing.

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