Bank Mergers and Small Firm Finance: Evidence from Lender Liability

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As a merger approaches, the value of repeat business for the target bank can drop sharply, so loan relationships between this bank and small businesses are often disrupted. Small firms sometimes experience serious value destruction as a consequence of this sudden lack of credit. This paper shows that lender liability may result from bank mergers and bankers involved in mergers often engage in aggressive, scorched-earth defense tactics to discourage further litigation. I summarize six lender liability cases to illustrate these points. Bank mergers have been shown to reduce credit availability in a number of studies. Since small firms depend on credit for their daily existence, owners of small firms do have a reason to fear a merger of their bank with a larger institution. Analyzing merger effects with survey data of firms obtained after a bank merger, an empirical strategy used in a number of studies, raises problems since the only firms considered are the ones that survived the bank merger. Suggesting that the problem will cure itself in the long run, an argument advanced in other studies, ignores small firms' daily dependence on credit. In the long run we are all dead. Bank examiners need to evaluate an institution's litigation experience and measure a bank's organizational architecture – its ethical climate. Banks which are repeatedly involved in lender liability lawsuits should be denied future mergers until there is a change in organizational architecture. To assist in evaluating organizational architecture, banks should be required to report their litigation expense on their call reports. Furthermore, regulators should seriously consider the recent suggestion of Carow, Kane and Narayanan (2006) that they take steps to ensure that participants in bank mergers preserve target bank relationships. Otherwise negative effects on small business lending and economic growth will continue as bank consolidation proceeds.

> B. Levy argues that although it survived the Great Depression, two World Wars and numerous recessions and economic cycles during its 108 year history, it could not withstand the wrongful actions of the Bank which destroyed B. Levy's wholesale and retail shoe businesses [after the merger].[1]

I. LENDER LIABILITY AND THE VALUE OF BANKING RELATIONSHIPS WITH SMALL FIRMS

The value of a bank includes the value of intangible assets such as repeat business from client firms (Greenbaum, Kanatas and Venezia (1989); Carow, Kane and Narayanan (2006)). As a target bank is merged, the value of repeat business to

[1] Judge J. Nealon of the Court of Common Pleas, Lackawanna County, Pennsylvania in a February 28, 2006 decision in a lender liability case (*Busy Bee v. Wachovia*, p. 4) after both a trial on liability issues and a damages trial (both by jury) totaling five weeks. The last three words in the quotation are added by the author for clarification; they refer to the merger of Third National Bank and Trust Company of Scranton and Corestates Bank.

that bank, and hence the value of banking relationships with these firms, declines sharply and may approach zero. On the other hand, the value of the banking relationship to the borrowing firm remains as before. Small businesses are thus often surprised to find that bank officers who had treated them very well in the past are suddenly much less accommodating to their credit needs and may not want their business at all. Carow, Kane and Narayanan (2006) suggest that the drop in credit availability to small firms after a bank merger is often a result of this phenomenon.

A large number of borrowers may be mistreated in some mergers, but bankers and their defense attorneys sometimes engage in aggressive, scorched-earth defense tactics to raise the cost of litigation for the plaintiff and make it less likely that these and similar cases will come to trial. Otherwise other similarly-situated borrowers would be encouraged to pursue their claims and the reputation of the bank would suffer. This paper summarizes six lender liability cases to illustrate these points. The paper suggests that these cases are not just random events but, to the contrary, may be the proverbial tip of the iceberg. Many similar cases are not litigated because of the expected cost. As of this writing, two of the six cases may not proceed to trial because of cost, one other was abandoned because of cost, one resulted in summary judgment for the plaintiff on the issues because of six years delay by the defense in supplying key documents, and one case cost about one million dollars to litigate. One case was settled in favor of the plaintiffs. I also document aggressive, scorched-earth defense tactics and delay in several lender liability cases other than the six considered here.

Examining lender liability in the context of bank mergers serves a number of purposes relevant to the literature in finance. The first purpose is to examine the hypothesis that serious value destruction to some small businesses results directly from the decline in credit availability following a bank merger. These are small businesses with loans from the target bank. The six cases are consistent with the hypothesis.[2] This paper fills an important void. While Carow, Kane and Narayanan (2005; 2006) find negative abnormal returns to smaller firms around bank merger event dates, and Berger *et al.* (1998) find a 16% drop in credit to small businesses after a merger, empirical studies of the effect of bank mergers on small businesses credit generally do not consider in detail (or often at all) what happens to a small firm when credit is withdrawn.

A second, very closely related, purpose is to document the value of bank relationships to small firms. There has been an explosion of econometric research on this issue in recent years, as illustrated by the publication of four summary articles since 2000.[3] The firms considered here are much smaller than those covered by event study evidence, for example, since most are not publicly traded. The value of bank relationships should be higher for firms with few alternative sources of

[2] Case study evidence has been used previously in analyzing the effect of bank mergers. See, for example, Rhoades (1998).

[3] Boot (2000), Elyasiani and Goldberg (2004), McNulty (2002) and Ongena and Smith (2000).

finance. Case studies provide detail on the value of bank relationships with small firms not found in large-sample econometric studies.

The third purpose of the paper is to reconsider the argument in several studies (e.g., Berger, Saunders, Scalise and Udell (1998); Jayratne and Wolken (1999)) that bank mergers have a neutral effect on small firms in the "long run". These studies find that three years after a bank merger the supply of small business credit returns to normal levels. The lender liability cases illustrate that this neutral long-run effect is completely irrelevant for small firms, most of which rely on credit on a daily basis. If a firm cannot pay its employees and suppliers, and conduct normal business operations, its reputation will plummet within days. Suppliers will refuse to deliver inventory. Imported goods will pile up at the port without financing arrangements. Key employees will leave the firm. Substantial management time will be diverted from productive activity to dealing with the shortage of credit.

Most business people dealing with a small firm assume that its problems with its bank arise from internal weaknesses. Confidence can be hard to attain but easy to lose, and financial problems are very often cumulative and difficult to reverse. New bank relationships take time to establish, and the cost of credit is higher with a new relationship.[4] For the typical small business, Lord Keynes famous observation that "in the long run we are all dead" clearly applies here.

The fourth purpose of the paper is to point out a survivorship problem in recent studies based on firm data after a bank merger. The cases show clearly that firms do fail in some cases when their line of credit is withdrawn. Hence they would simply not appear in any sample data after the merger. A study of small firms by Scott and Dunkelberg (2003) finds mergers had no effect on the ability of the firms to obtain a loan, but there were negative effects on the cost of credit (non-price loan terms and fees) and deterioration in service quality. The firms in this survey are the survivors.[5] The analysis by Jayratne and Wolken (1999) and the study by Berger, Udell and Rosen (2007) may also raise survivorship issues, and this would be true of other such studies based on firm data after a bank merger.

The fifth purpose is to help researchers understand the phenomenon described in a recent lead article in the *Journal of Finance by* Garmaise and Moskowitz (2006). They find a surprising relationship between bank mergers in a local area and a subsequent increase in property crime.[6] They hypothesize the link is a drop in credit availability induced by a decline in competition in the local banking market and a resulting decline in local economic activity. Lender liability in the context of bank mergers provides a much more compelling explanation of their results. If bank mergers destroy some small firms, increased unemployment and property crime may indeed result, regardless of the effect on bank competition.

[4] For example, Berger and Udell (1995) find that small firms with longer relationships are charged lower interest rates and are less likely to be required to have collateral.

[5] I am grateful to Jon Scott for pointing out this implication of my research.

[6] These authors summarize a large empirical literature on the effects of bank mergers on credit availability.

In summary, most empirical studies of the effect of bank mergers do not consider what happens to the small firms when credit is withdrawn. This paper attempts to fill this gap. These case studies illustrate many aspects of small firm dependence on bank credit that have not been previously considered in the finance literature. Lender liability cases are an important source of such information. Cappello and Komoreske (1993) and Budnitz (2006) describe thousands of such cases in the 1980s and 1990s.

A bank merger may be a cause of lender liability, for four closely related reasons. The first is the diminished value of repeat business to the target bank, as already noted. The second reason is described in detail in Section III. Loan officers and managers of the acquiring bank and the managers of the target bank may have different views on the type of loans that should be in a bank's loan portfolio. This is particularly likely if the acquiring bank is large and the target bank is small, but the phenomenon is not confined to such cases. (A merger which created one of the six lender liability cases is First Union-Wachovia.) Banks lending to small firms often make use of soft information while larger banks tend to rely more on hard information. An economic agent generally avoids actions which might damage his or her entire career. Thus, job concerns may prompt loan officers at the target bank who had previously relied on soft information in making credit decisions to withdraw credit from some of these firms out of fear that these loans might be criticized by the new bank managers.

A third reason is that the due diligence requirements imposed on bank merger participants may prompt a bank to clean up its balance sheet. Importantly, this argument would apply even several years before a merger, if a bank is positioning itself to be acquired. A loan officer may become difficult to deal with and unaccommodating to a firm's credit needs as a result. For the firm this can appear to be a sudden change, even though it represents complex developments in the bank over a longer period.

I will briefly illustrate the first three reasons with two cases. In one case, a bank officer told a CEO of a small family-run business customer with a fifteen year relationship with the bank that the bank no longer wanted to make loans in the trucking industry. Several bank officers told the firm's CEO, "they want you gone". The bank imposed $750,000 of overdraft charges, substantially reducing the firm's net worth. The bank was involved in a merger shortly afterwards.

In another case, a furniture retailer with an 18-year relationship with the bank (and purportedly the bank's best business customer) suddenly experienced denial of a new loan that had been promised earlier. He had made important business decisions in reliance on the verbal loan commitment. The bank merger had already been announced, and the bank president who made the decision to deny the loan had been attending seminars on the acquiring bank's lending practices *at the very time he made the decision.*

Much more money is involved in a bank merger than in even the largest lender liability lawsuit so bank managers may reason that they are acting in the best interests of shareholders.[7] A merger price may be higher with a cleaner balance sheet and reduced due diligence requirements. Unscrupulous bank managers might actually offset the results of lender liability versus the merger advantages.

A fourth possible reason that a bank merger may result in lender liability concerns loan covenants. Covenants are usually part of a loan agreement, but when a loan is made, or perhaps several years after, the loan may be in violation of one or more covenants. Banks do not automatically foreclose under such circumstances. This point is quite clear in the recent analysis by Demiroglu and James (2007). Indeed, covenants may be simple boilerplate agreements – routine documents drawn up by bank attorneys to cover a wide range of situations. Officers of the target bank that originally made the loan may have no intention of enforcing every item in the covenants. However, when the bank is involved in a merger, the expected increased scrutiny of all loans during the due diligence process may subject loan officers to embarrassment.

For example, in the Gulf Components case (Section IX), the plaintiff noted that his loan violated certain covenants from day it was made. The loan officers at First Union (the target bank) ignored the covenant violations until the time of the merger. After the merger, and with the company's aircraft parts business depressed by the recession and the events surrounding September 11, 2001, the bank forced the firm to refinance and also swept the company's deposit accounts.

Many cases involve bank officer behavior found by the courts to be either "egregious" or "outrageous" or both. One jury found that a bank involved in a merger destroyed a 108-year-old Scranton, Pennsylvania, family business to remove the loan from its balance sheet. The jury awarded $17.3 million to the plaintiffs, including $7.0 million of punitive damages.

My research adds to knowledge in both law and finance. I consider the law and economics of small firm finance in the next section and then present two brief theoretical sections. Section III considers the effect that a change in organizational structure can have on the use of soft information in lending decisions. Section IV considers the value of repeat business in the context of a merger and typical defense strategies in lender liability. Sections V through X summarize the lender liability cases. Sections XI and XII offer policy recommendations and Section XIII concludes.

II. THE LAW AND ECONOMICS OF SMALL FIRM FINANCE

Small businesses are dependent on credit for their very existence. Best-selling author Martin Mayer (1997) reflects: "every successful businessman had his banker, as he had his lawyer and his accountant." The U.S. Supreme Court agrees. In the landmark decision in *United States v Philadelphia National Bank* (1963), which forms the legal basis for the federal bank regulatory agencies' antitrust activity

[7] Brickley, Smith, and Zimmerman (2002) suggest that a firm's ethical behavior is priced in financial markets. Research into the effects of lender liability decisions on bank stock prices is a potentially interesting area for research but is completely beyond the scope of this paper.

to this day, the Court wrote: "If the businessman is denied credit because his banking alternatives have been eliminated by mergers, the whole edifice of an entrepreneurial system is threatened."

This fundamental point, although obvious to any small business owner and anyone who has taught financial management, is often disputed by defense attorneys for financial institutions in lender liability cases. However, it has been upheld in many decisions, such as *KMC vs. Irving Trust* (1985) and *Ricci vs. Key Bankshares of Maine* (1987). McNulty (2002) notes these cases reflect acceptance by the courts of the academic finance notion that bank relationships create value for both the business firm and the bank (e.g., Diamond (1984); James (1987); Boot (2000); Elysiani and Goldberg (2004)). Hence the destruction of these relationships involves value destruction, such as occurred when bank relationships were destroyed during the Great Depression (Bernanke (1983)).

Nonetheless, scorched-earth, contrary-to-fact, zealous-advocacy defense tactics (e.g., Rosenbaum (2004)) are sometimes successful in lender liability. (As noted, this point is important in understanding why many lender liability cases never go to trial.) For example, Barnett Banks vs. Shirey (1995) is a case in which an appeals court accepted this type of defense and denied the obvious connection between credit availability and firm performance for a retail firm which used bank credit to finance its inventory. (I analyze the appeals court decision in Appendix I). Table 1 presents examples of defense tactics employed in various lender liability cases. For completeness, I include cases other than the six analyzed here.

An econometric analysis of bank balance sheet data from 1980 to 1995 (Berger, Saunders, Scalise and Udell (1998)) finds an aggregate "static effect" of a $25.8 billion drop in small business lending (in real 1994 dollars) from a melding of bank balance sheets after bank mergers. This is equivalent to 16% of total small business lending, or the aggregate small business lending of all banks under $100 million, in 1995. They suggest that much of this is offset in the long run by the reaction of competitors and by the entry of new banks. The long run in their study is three years after the merger. Jayaratne and Wolken (1999) use similar reasoning: "The probability of a small firm having a line of credit from a bank does not decrease in the long run when there are fewer small banks in the area, although short-run disruptions do occur . . . . Bank consolidation will have little long run effect on credit availability to these firms." I noted earlier that the cases considered here show that the long run is not a relevant time horizon for small firms. This is important because Scott and Dunkelberg (2003) find 25% of the small business firms in their survey had been affected by bank mergers.

Carow, Kane, and Narayanan (2005; 2006) report event study evidence consistent with my argument. They find that small, credit-constrained businesses experienced a negative share price reaction to the Financial Services Modernization Act of 1999 and to bank megamergers. They also note considerable anecdotal evidence of dissatisfaction in the business community with the effects of bank mergers on credit and service availability. Most firms in my study very small and not publicly traded. These types of firms have few alternative sources of finance other than

Table 1: Examples of Bank Defense Tactics Employed in Various Lender Liability Cases

Case	Summary of Relevant Developments
Taco Prima	The depositions of the plaintiff and his spouse dragged on for several weeks with numerous pointless discussions. The bank did eventually settle the case for $500,000 when faced with damage estimates for the loss of the business of over $1 million and evidence that the Bank had violated its own loan policies.
Gulf Components	The attorney for the Bank dragged the case on for about four years by filing a Motion for Summary Judgment to dismiss the lender liability claim against the bank and enforce the one, remaining outstanding loan. Summary judgment can only be granted if there are no genuine issues of material fact, which was clearly not the situation. The bank's sweeping of Gulf's transactions accounts and it's creating large cash flow problems for Gulf by terminating an interest rate swap after only two years with a $254,000 swap termination fee were clearly issues of fact in terms of their impact on the business. Each time a hearing was set for the judge to hear the Motion for Summary Judgment, bank counsel moved to postpone the hearing at the last minute. This forced Gulf's counsel to prepare and re-prepare for several hearing. This increased the cost to the company substantially. The bank continued this strategy of delay for several years.
West Florida	Despite the loss of a business with over $1 million in net worth, West Florida has not actively pursued litigation because of the large amount of anticipated legal expenses
Onyx Insurance	Despite the loss of a business with $12 million in shareholders' equity, Onyz did not pursue litigation because of the large amount of anticipated legal expenses.
Ambrosia Coal	The Court imposed sanctions on the bank for "willfully and purposefully" withholding documents for six years "thereby obstructing the development of plaintiff's case." The Court said that Board minutes containing merger discussions, information vital to plaintiff's claims, was deliberately placed beyond plaintiff's reach. The evidence withheld was crucial to plaintiff's case in that it could demonstrate the merger was a motivating factor for defendants' conduct. This conduct was found to have prevented plaintiffs from fully deposing key witnesses; two of the witnesses had since died. Defendants' conduct amounted to willful and bad faith behavior; plaintiffs had "stonewalled" plaintiff's case.

(*Continued*)

Table 1: (*Continued*)

Case	Summary of Relevant Developments
	The documents at issue were minutes of the meetings of the Bank Board of Directors where the merger was discussed, as well as handwritten notes from these meetings. The plaintiffs argued that these minutes would show that B&T was in the process of buying People's Bank and that the merger was a motivating factor in the liquidation of the CDs. The plaintiffs made four requests for documents beginning in October 1996. The court had earlier granted two other requests for sanctions against defendants' counsel on other matters.
	The court also found: "defendants' failure to appropriately respond to plaintiffs' discovery requests delayed the case and prevented plaintiffs from further discovery (of) information vital to plaintiffs' cause of action. The court finds this discovery infraction to be egregious." At another point it noted "the court concludes that defendants' conduct in continuing to withhold board minutes, which they knew or should have known were available and relevant to the instant litigation, exacerbated by defendants' past behavior which caused two sanction orders to be imposed against them, amounted to willful and bad faith behavior".
	"Plaintiffs' case would not have been delayed had the board minutes been produced when requested and plaintiffs would have had the opportunity to fully develop their causes of action by deposing crucial witnesses to the B&T merger. By precluding this evidence, defendants obstructed the development of plaintiffs' case, thereby preventing it from moving forward."
Busy Bee	The plaintiff spent about $1 million in attempting to overcome all obstacles to bring the case to trial. There were two trials totaling five weeks, one on the liability issues and one on damages. The case took over ten years to litigate (1996 to 2006). The court found that the bank was clearly liable for destroying a 108 year old, small family-run business. As of the date of the judge's opinion, as summarized in Section X (February 2006), the bank appeared to be planning to appeal.
Shirey	On appeal, defendants convinced an appeals court that small businesses do not need credit to survive in a retail business, despite numerous court decisions to the contrary. The crucial economic issues in the Appeals Court's decision are analyzed in Appendix I.

(*Continued*)

Table 1: (*Continued*)

Case	Summary of Relevant Developments
Joseph	The bank implicitly admitted it was in error, yet it spent about $1 million to defend the case and, arguably, set up numerous obstacles to discourage any attorney from suing that bank, or any bank, especially on a contingency. The bank was sued for representing that a piece of land it sold to Joseph was zoned commercial. The bank never disputed that the land was actually zoned agricultural and was therefore worth approximately $10,000 to $15,000 less. The bank's only defense was that it was entitled to consider the land as zoned commercial because the bank's files said so! Rather than settle, the bank spent close to $250,000 to defend itself. The jury awarded $90,000 to Joseph. According to Joseph's counsel, the bank then used political connections to have the jury verdict thrown out. The judge deciding this issue retired and could not be disciplined. The bank settled during a second attempt to try the case, but then hired an attorney at $400 per hour to contest every dollar of Joseph's counsel's legal expenses. In summary, the bank spent about one million to defend itself on an issue worth about $90,000, at most, in which it was clearly wrong.
DaRocha vs. Crusader Bank	DaRocha, an individual, sued the bank in 1994 for negligence in the administration of a construction loan on his home in 1992. The original complaint contained approximately 121 factual allegations concerning breach of contract, fraud and misrepresentation. This number was subsequently expanded to 144. The bank filed numerous motions to have these removed but all were ultimately unsuccessful. The bank president, a local political figure, told DaRocha he would bankrupt him and he would never see the inside of a courtroom. The bank did not even file an answer to the complaint until 2001. The bank subsequently changed counsel three times, and each change required new counsel to take time to become familiar with the case. The bank president has never been made available for deposition. The case has not been tried as of January 2008.

Case references are shown below.

bank credit, and are thus even more subject to adverse effects when credit is withdrawn. Bank mergers thus may have a more serious effect on credit availability to small businesses than once thought. Discussing their event study evidence of damage to small, credit constrained firms, the authors comment. "These findings are worrisome . . . Given that smaller companies create the largest portion of new jobs in our economy, our results suggest bank consolidation may adversely affect the job-creating capacity of the small business sector. For this reason, we urge regulatory officials to . . . place increased emphasis on how acquirers plan to preserve target bank relationships" (Carow, Kane and Narayanan, 2006, p. 834).

The theoretical framework of the paper is based on work by Limberti (2006), Greenbaum, Kanatas and Venezia (1989) and Carow, Kane and Narayanan (2006). The argument is that small-business loans at small banks are generally relationship loans; these give banks an important way to reduce the asymmetric information inherent in financial transactions (Diamond (1984); Boot (2000)). In a loan relationship, loan officers acquire soft information about the borrower. Any change in a loan officer's position in the organizational structure after a merger may make transmission of this information about the borrower difficult or impossible, and this occurrence may impede credit decisions. Credit decisions based on qualitative information may be frowned on, and loan officers at a merged bank are not likely to deliberately jeopardize their jobs. The small business lending relationship is the victim. This is a microeconomic phenomenon; it may not be apparent in aggregate data.

My empirical evidence consists of six lender liability lawsuits associated with bank mergers. All of the six cases show an economically damaging decline in credit to small firms.[8] There was a corresponding effect on real economic activity, although it would not be seen in aggregate data, even at the county level.[9] My analysis thus provides the detail on the process whereby bank mergers reduce aggregate small-business credit (Berger *et al.* (1998)).

Suing a large financial institution is expensive and time consuming. Many cases like those I summarize never go to trial. In fact, only one of my six cases (Busy Bee in Section IX) did go to trial. The plaintiffs in that case spent over $1 million in legal expense to bring the issues before a jury. Three of the six cases were not litigated seriously because of the potential expense. One other case was settled, and one resulted in a default judgment in favor of the plaintiffs because the bank had withheld documents for six years. If there is a jury trial but no judicial summary, or if the case is settled, the details would generally be unavailable to researchers who are not familiar with the specific case.

[8] The evidence on economic damages is clear in every case except Ambrosia Coal (Section VIII). Even in this case the firm argued it experienced lost profits and an inability to meet its surety bond requirements to insurers because the bank had liquidated its collateral.

[9] For example, the 370 retail jobs lost in an economically disadvantaged area of Pennsylvania described in *Busy Bee v. Wachovia* represent a real economic effect. Even this effect may not show up in aggregate economic statistics; such statistics may be inadequate for measuring the economic effects of bank mergers.

The cases I summarize are thus a representative sample of what might happen to a small business when its bank is taken over by another institution. The information has been compiled over many years and comes from various sources including expert witness files,[10] information provided by attorneys, and legal databases.[11] Lawsuits are inherently heterogeneous so it is somewhat unusual to find six cases with very similar fact patterns.

There were approximately 3,500 bank mergers in the ten-year period ending in 2003 (Prager (2004)). It is impossible to know what happened to all of the small business customers of these banks. Many of the mergers involved two small banks. In a merger of equals, bank relationships may be recognized as a source of value and retained. In a merger involving one small and one large bank this is not necessarily the case. The propensity to lend to small firms, measured, for example by the ratio of small business loans to total assets, is much smaller for large banks than small ones (Berger *et al.* (1998)).

Comprehensive summary volumes of lender liability (Cappello and Komoroske (1993) and Budnitz (2006)) do not discuss bank mergers. Even when Cappello and Komoreske discuss “where problems arise” they do not cite mergers as a cause of lender liability. Budnitz (2006) rejects the notion advanced by some legal scholars that lender liability is out of date, but does not mention bank mergers to support the argument.

III. A MODEL OF LENDING DECISIONS UNDER DIFFERENT ORGANIZATIONAL STRUCTURES

I draw on work by Berger, Miller, Petersen, Rajan, and Stein (2005), Cole, Goldberg and White (2004), DeYoung, Hunter, and Udell (2004), and Limberti (2006) to describe the ways changes in a bank’s organizational structure might affect credit decisions.[12] While the construction is simple and not substantially different from this literature, it provides an important theoretical tool that will serve to explain the actions of the bank in the lender liability cases.

[10] To provide complete disclosure, I served as an expert witness and consultant in three of the six cases (Taco Prima, Gulf and West Florida) but I did not testify since there was no trial in any of these cases. I had no involvement in the other cases. The discussion in the paper of Ambrosia and Busy Bee is based entirely on the trial judge’s written opinion. The discussion of *Onyx* is based on an affidavit and a conversation with the attorney for the firm.

[11] Budnitz (2006) lists approximately 4,000 lender liability cases; Cappello and Komoroske (1993) list about 1,000. This case law begins in the 1930s, but most of the cases are from the 1980s and 1990s. These lists only include cases which the authors cite as precedents or illustrations. The theoretical population of all potential lender liability abuses, including those that were never litigated, is thus much larger than 4,000. On the other hand, not all of the cases listed by these authors involve bank mergers and in some cases the court did not find the lending institution to be responsible for the damages.

[12] Limberti (2006) relies on Aghion and Tirole (1997), which he describes as “one of the most significant contributions to the organizational design literature” (p. 7). Aghion and Tirole suggest that formal delegation of authority to lower levels of a hierarchy can promote initiative and effort so that agents care about outcomes. In his empirical analysis, Limberti finds greater use of soft information when formal authority has been delegated. (The Barnett Bank model of community banks in a holding company which is discussed in the conclusion of this paper would fit this framework reasonably well.)

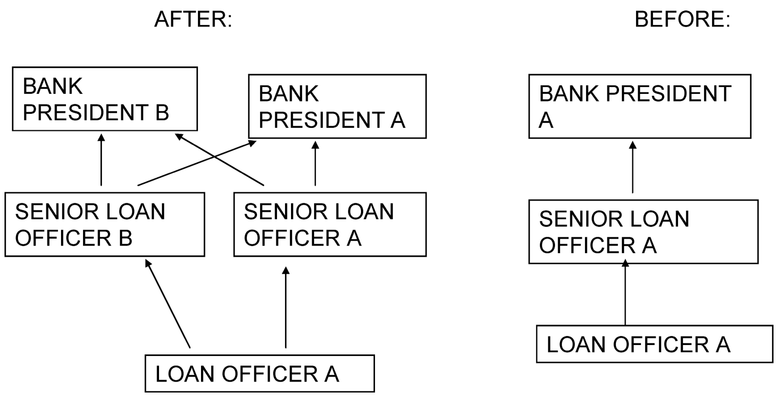

Figure 1: How Credit Decisions are Made before and after a Bank Merger.

Soft information is information that cannot be quantified and credibly communicated from one agent to another. Examples include a borrower's work ethic, honesty and relationships with suppliers, customers and employees. For a bank, hard information would be relatively easily verifiable data generally accepted as an appropriate basis for making impersonal credit decisions.[13] Examples would include financial ratios, cash flow estimates, comparisons with industry norms, and the results of credit scoring models.

Limberti (2006) points out that the use of hard versus soft information varies with the authority delegated to the account officer handling an account. This is consistent with the finding of Berger *et al.* (2005) that larger banking organizations make greater use of hard information. Bank officers with limited authority must convince superiors of the accuracy of their information. In more formal organizational structures, hard information is easier to transmit than soft information.

Limberti tests within one large banking organization in Argentina which focuses on global credits to determine if a loan officer who receives more authority uses more soft information. He finds that the results support this hypothesis.

Figure 1 hypothesizes a simple organizational structure for a bank before a merger. Loan Officer A reports to Senior Loan Officer A, who reports to Bank President A. We assume all three serve on the bank's loan committee, which makes the credit decisions. Loan Officer A gathers both hard and soft information about prospective credits, and analyzes and transmits this information to his supervisors and to the loan committee. The committee may rely considerably on soft information in making some credit decisions. This does not mean hard information is disregarded, but rather that soft information is valuable because at a small bank, senior managers are familiar with both Loan Officer A and the borrower.

[13] One interesting item is unaudited financial statements, which may be acceptable to small banks if they have other reliable soft information. Larger banks may find such information unacceptable in making credit decisions.

After a merger, or, even in anticipation of one, the new organizational structure becomes B. (We assume Senior Loan Officer A and Bank President A remain with the organization.) Loan Officer A now knows his work will be reviewed by Senior Loan Officer B and Bank President B. They do not know him, and he does not know them, except perhaps on a perfunctory basis, so it is harder for him to produce and rely on soft information. Larger banking organizations will rely more on hard information in making credit decisions.

Limberti (2006) models organizational change within one large bank that resulted in more decentralization of authority and greater use of soft information as a result. I assume instead greater centralization and loss of autonomy by individual loan officers. I predict that organizational differences affect credit decisions and the cases I summarize confirm that result.

IV. GENERALIZABILITY OF THE CASE STUDY EVIDENCE: THE VALUE OF REPEAT BANKING BUSINESS AND THE ROLE OF SCORCHED EARTH DEFENSE TACTICS

One important aspect of the value of a bank is the value of future business from existing clients, as in the models of Greenbaum, Kanatas and Venezia (1989) and Carow, Kane and Narayanan (2006). As a merger approaches, the value of repeat business to the disappearing institution declines and may approach zero. Bank officers may thus suddenly disregard the needs of business customers they once served willingly. We analyze this phenomenon in more detail because it is central to the theme of this paper and it suggests that these six cases may be only the proverbial tip of the iceberg. There may be many other such cases that do not get litigated, particularly in view of Berger *et al.'s* (1998) abovementioned estimate of an aggregate 16% drop in small business lending after bank mergers.

Greenbaum, Kanatas and Venezia (1989) point out that a central theme in studies of relationship lending is externalities: "The bank shares in benefits transcending the ostensible return for which it contracts" (Greenbaum, Kanatas and Venezia (1989)). These benefits include future loans, deposit business and the sale of other financial services. They show that, even in an analysis with an infinite time horizon, the value of repeat business to the bank declines over time as the borrower is continually exposed to offers from competing lenders. They assume a competitive loan market, but an information advantage in a relationship loan produces quasi-monopoly profits. The information monopoly is not absolute, since competing lenders are capable of gathering similar information, with effort and over time. Nonetheless, the relationship bank possesses superior private information about the probability of repayment because of its past lending experience. Because of its knowledge of the client's probability of default, the incumbent bank is initially able to make an informed loan offer and retain the customer's business for several future periods.

Once the firm accepts the offer, search costs, and the bank's information advantage preclude competitors from making a comparable offer in the short term.

Since competing lenders don't know the firm's true financial condition, their loan offers are initially greater than the relationship lenders' offer, R_{ij}. Thus, in the first few periods the firm continues to borrow from the incumbent bank. However, *the greater is the length of the relationship, the larger is the probability that a competing lender will make a successful offer of* $R < R_{ij}$. This competing offer is priced aggressively below the marginal cost of funds, because of the probability of future economic rents from the relationship advantage. Thus, the value of repeat business to the relationship lender declines over time because he knows that eventually another lender will make a successful offer and the relationship will terminate. Thus, "as the bank-client relationship endures, the client becomes less valuable to the bank" (Greenbaum, Kanatas and Venezia (1989)).

They note that their result is similar to that of Blackwell and Santomero (1982) in the context of credit rationing. However, the Blackwell-Santomero result occurs because the profitability of the bank from repeat customers is less than from new customers because the elasticity of the demand for loans is greater for existing customers. In other words, the bank has less monopoly power over established customers with good credit records. The established customers are the first to experience credit rationing, if it occurs. In the Greenbaum, Kanatas and Venezia (1989) paper, in contrast, the result occurs because the dispersion of client cash flows decreases with the length of the relationship.

In this model, customers terminate their bank relationships voluntarily because they can obtain a better loan rate elsewhere. However, the transition may not be smooth. Although Greenbaum *et al.* (1989) do not consider the point, the model can be used to analyze the value of bank-borrower relationships during bank mergers. This is an essential part of the recent analysis of Carow, Kane and Narayanan (2006). The value of a bank is the value of tangible and intangible assets less the value of tangible and intangible liabilities. The value of repeat business is one element of the value of the intangible assets. During a bank merger, the value of repeat business for the disappearing institution declines, and may approach zero. Thus, there is a greater incentive for the lender to behave opportunistically toward long-time business customers. Businessmen are often surprised when the financial institution that nurtured their growth and faithfully met their financial needs suddenly loses any interest in serving the firm.

Carow, Kane and Nayaranan (2006) begin with the observation that an established bank relationship gives the bank privileged information about the borrowing firm and hence an ability to price the loan more accurately than the competition. They view this ability as an intangible bank asset. Both parties share in the benefits of a relationship, so realization of the value of the intangible asset requires the cooperation of both parties. This fact gives each party bargaining power. During and after a bank merger, a customer's bargaining power may be altered, particularly if the loan officers who dealt with the firm and viewed its operations favorably fail to survive the merger.

Extending their analysis to the case where the merger produces a major change in the corporate organizational structure, the value of the intangible asset may decline sharply for the disappearing institution. (Other factors, such as the point noted earlier that the loan may violate some loan covenants which were previously overlooked, may also play a role here.) In a merger, the value of repeat business emphasized by Greenbaum, Kanatas and Venezia (1989) can suddenly become zero for the target institution. This creates the incentive for loan officers to treat the borrowing firm opportunistically.

Opportunistic behavior by banks is the focus of lender liability. For example, in *KMC vs. Irving Trust* (1985) a bank cut off financing to a retail firm without notice, causing the firm to fail. The court was not impressed with the argument that the loan contract (written by the bank) allowed the bank to do this, and awarded \$7.5 million in economic damages to KMC. This case became a landmark in lender liability. In *Ricci v Key Bankshares of Maine* (1987) a real estate developer was subject to similar behavior by its bank and eventually obtained a judgment for \$15 million, which includes economic and other damages. Neither of these cases dealt with a bank involved in a merger, at least according to the summary information which is publicly available.

Bernanke's (1983) analysis of the Great Depression is illustrative of what we see in lender liability cases. When numerous banks failed, bank relationships were destroyed. The destruction of relationships wipes out real economic value. Bernanke argues that although this didn't cause the depression, it made it worse by increasing the real cost of intermediation for small firms, farmers, and consumers. Lender liability is a microeconomic reflection of what Bernanke (1983) found at the macroeconomic level. These cases thus allow us to obtain a greater understanding of the value of bank relationships.[14] While this subject has been studied extensively using econometric analysis of large databases, ultimately, each small business situation is different. Observing the details of what happens to a firm when a bank relationship is destroyed adds to our understanding of the value of relationships.

The Role of Scorched Earth Defense Tactics. Given that loan officers of a bank involved in a merger may have various incentives to walk away from previously beneficial bank-firm relationships, why do we not see more of such cases in an era where there are several hundred bank mergers each year and the disappearing institution in each case has numerous business loan customers? Why have other such cases not come to the surface? Lawsuits are inherently heterogeneous. The fact that one researcher can locate six cases with similar fact patterns suggests that these cases are not unique. I suggest that these cases may be just the proverbial tip of the iceberg. The answer to the question of why this phenomenon is not better known lies at least partly in the probable outcome if the case goes to trial, the real and anticipated cost of litigation to the plaintiff, and the anticipated response of the bank defense team.

Breach of contract is one of the oldest and most well developed areas of lender liability. Patterns of past dealings, such as regular loan renewals, verbal statements

[14] McNulty (2002) expands on this argument by presenting relevant finance literature, lender liability summaries and damage awards in such cases.

that funds will be forthcoming and other evidence of a loan relationship, have often been held to constitute an implicit contract. The courts have found value destruction in breaches of commitments to lend money to firms and farmers since at least the 1930s.[15] Thus, when a bank is charged with damaging or destroying a small, family-run business, the possibility of a large damage awards becomes obvious to both parties. Indeed, plaintiffs often seek and sometimes obtain punitive damage awards in such cases. The point that there was a multibillion dollar merger going on at the same time, possibly diverting bank management's attention, will not make it easier to defend the bank's case.

On the other hand, banks have developed aggressive defense tactics in such cases. One technique is simply to deny everything, including the most obvious points. Appendix I presents an example of a bank that was able to convince an appeals court that small retail firms do not depend on credit. If the evidence against the bank is strong, an additional common defense tactic is delay. This can be accomplished through a variety of legal mechanisms. Table 1 presents examples of denial, delay and obfuscation in the six cases, and it also provides similar evidence from other lender liability cases. Again, this information is often not in the public domain[16] so the evidence offered in Table 1 is only a small sample. It is reasonable to presume that small business and their advisors know that this is the type of defense strategy they may be facing, and many choose not to subject themselves and possibly their family to the possibility of endless delay, leading to possible financial ruin. The incentives for the firm *not* to litigate are thus quite strong. If litigation were easier, or if there were provisions for arbitration in lender liability cases involving bank mergers (a suggestion I make in Section XII), we would no doubt see many more of these cases. An aggressive bank defense is thus a key part of my hypothesis.

I now consider the six cases.

V. TACO PRIMA AND WAREHOUSE WICKER

Taco Prima, Warehouse Wicker et. al. vs. Florida National Bank (Indian River County, Florida, 1991). In a suit for breach of contract, a bank involved in a merger refused to fund a promised loan to one of its best business customers with an 18-year relationship with the bank.

Florida National Bank in Vero Beach was a member of a small statewide holding company; total assets of the bank were about $90 million immediately before the holding company was acquired by First Union. Warehouse Wicker was a new venture importing furniture from the Philippines and six other countries. The principals had made several trips to the Philippines, and had taken orders, received deposits, and scheduled deliveries to retail outlets.

[15] See *Hunt vs. United Bank and Trust Company of California* (1930).
[16] It is impossible to summarize every aspect of every case. Thus, information of this nature is frequently buried in court records and transcripts and not shown in published summaries in West law, Lexis-Nexis or other databases.

When the bank reneged on its promised line of credit, containers of furniture piled up on the docks in Miami; Warehouse Wicker incurred storage charges and could not pay its suppliers. The breach resulted in other damages as well, including loss of suppliers, loss of customers, and loss of good will and reputation. Because the owner was not generating cash flow from the new business, he had to keep his old retail business in operation, contrary to the original business plan. The lack of funding, and the time required to operate two businesses, caused the new business to struggle and ultimately fail.

Interestingly, the loan commitment at issue was oral; Florida law at the time (while subsequently changed) did not require a lending commitment to be in writing to find a breach of contract. Moreover, Florida National's loan policy statement contained specific statements that the bank intended to honor all commitments, whether oral or written, and that it intended to meet the needs of its long-standing customers. There was also a history in the particular loan relationship of reliance on oral commitments.

The business owner, Dominic Saracino, had been a customer of the bank for 18 years. Thomas Dudich, the officer who had handled the account for several years, told Saracino he was the bank's best business customer. When Saracino initiated plans to scale back his retail furniture business to begin importing furniture, Dudich assured Saracino that the bank would support and fund the new venture. Saracino was an experienced furniture retailer connected with other retailers who planned to use his expertise and connections in his wholesale furniture operations. He already had a list of retailers who wanted to buy from him.

The proposed loan was a standard working capital loan for $150,000 (primarily for inventory) to be personally guaranteed by Saracino, who, according to the Bank's records had a net worth of over $950,000. The loan would be a new loan that would replace Saracino's then current line of credit for the retail operation, which would be closed.

The loan went to Florida National's loan committee on July 20, 1988. Bank records indicate five loans scheduled for discussion that day, but the minutes of the meeting indicate that only four loans were considered. The Warehouse Wicker loan was not discussed; it was simply vetoed by the Bank President, George Curtis. Subsequent personal conflict within the bank between Dudich and Curtis over the handling of the Saracino loan eventually forced Dudich to leave the bank.

Curtis had been President of the bank for about three years. Dudich had kept Curtis informed about the Warehouse Wicker loan and, according to Dudich, Curtis himself had earlier given oral approval:

> "We put together a financial statement and pro forma of what sales could be expected during the first year, perhaps . . . . indications of interest . . . . There are retail stores out there that would be willing to buy from him. [We] put that package together [and I] discussed it with Mr. Curtis at some point. Mr. Curtis said we should go ahead and do it, go ahead and prepare it and write it up, and [I] relayed that information to Dominic. . . . We went through all the plans Dominic had for imports and exports. At that point is when I

gave Dominic the information that we were going to go ahead, and it had the backing of the President, and I was preparing to go to the committee. Dominic asked me if he would get the full $200,000. I said I can't answer that right now, it has to go to the committee. I said you should at least get most of it. I may have said you will get at least 150. I did tell him he would get most of it." Taco Prima *et al.* v. Florida National Bank, Deposition of Thomas Dudich, October 30, 1991, pp. 19–20.

Thus, it was the Bank President's earlier support that caused Dudich to tell Saracino that he would get at least $150,000 and maybe $200,000 for the new venture. Curtis's actions in the loan committee were thus a complete reversal and a major surprise to Dudich and Saracino.

In his deposition, Curtis gave four reasons for rejecting the loan, two of them appear to be contradicted by Dudich's testimony and other case facts, and one is inconsistent with his own testimony. The remaining reason is concern about political instability in the Philippines. How this would affect the bank's position was never made clear. The plaintiff argued strongly throughout the case that the real reason for rejecting the loan was the proposed merger with First Union.

Saracino complained bitterly to Dudich and to Curtis about the way he had been treated. As a result the bank undertook various efforts to secure additional financing for Saracino, including recommending him to a competing lender, Barnett Bank.

Several years later in his deposition, Dudich described the proposed venture favorably in great detail and described Saracino's success in his retail business. Asked his opinion about the matter in his deposition, Dudich stated about Saracino, "I don't feel he was treated properly"[17]

Curtis confirmed that he knew about the merger at the time he rejected the loan in the loan committee. When asked about the merger, he stated, "I hoped that would happen".[18] At the time of these events, or soon after, he was *already attending seminars with First Union to learn about their desired loan criteria*. Very soon after, he was made Area President of First Union's Sarasota and Manatee operations in another area of the state, giving him responsibility for a much larger bank and about 200 people.

The bank's loan file indicates that there was no rationale for a loan rejection on the basis of creditworthiness; Saracino's retail business met all the Bank's criteria in terms of net worth, cash flow, payment history, and other financial requirements. His profit margin was well above that of other retailers and the business had doubled in size in only a few years. The loan was also consistent with other requirements of the bank's loan policy statement.

The Bank President's actions also constituted a violation of other aspects of the bank's loan policy statements. Crucial evidence establishing this point is statements in the Bank's loan policy manual that "FNB expects to honor all commitments, whether written or verbal" and that it would respond "affirmatively" to the needs

[17] Taco Prima *et al.*, Dudich deposition, October 30, 1991, p. 26.
[18] Taco Prima *et al.*, Curtis deposition, March 6, 1992, p. 100.

of its business customers.[19] The manual also suggests that oral commitments are part of the way the Bank does business. Furthermore, it indicates that the success of the Bank's lending effort depended on the good judgment of its loan officers, and senior management should rely on these judgments and not involve itself in the business of making individual credit decisions. After five days of depositions of the plaintiffs, the case was eventually settled in favor of Saracino for $500,000, about half of the company's estimated economic damages.

The facts of this case fit the theoretical models presented in Sections II and III very well. A loan officer had communicated soft information about Saracino to the loan department. After Florida National's proposed merger with First Union, a much larger organization, the soft information apparently became much less relevant. Also consistent with the theoretical model, the value of future banking business with Saracino to Curtis (acting primarily in his own interest and that of his new employer, First Union) was virtually zero. Thus, a loan that would almost certainly have been made, based on the smaller bank's loan criteria, was subsequently rejected.

Curtis may well have suspected that due diligence by First Union would tag the new loan as an outlier or an undesirable credit, but there is no specific information on this issue in the case file. Nonetheless, as noted, Curtis was already attending seminars about First Union's desired loan criteria. The denial of credit had real economic effects in the demise of the Saracino business. This is consistent with research on the link between banking and real economic activity (e.g., Levine (1997)).

VI. WEST FLORIDA TRUCK BROKERS[20]

West Florida Truck Brokers vs. Southtrust Bank (Lee County, Florida, 2003). West Florida, headquartered in Fort Myers, had had a successful loan relationship with Southtrust Bank for over fifteen years (1985 to 2000). The firm provided independent truckers who haul produce and other products for major grocery chains, including Great Atlantic and Pacific Tea Company (A&P). The West Florida loan at Southtrust was an asset-based loan to finance accounts receivable. These loans are paid off automatically as the receivables are collected. The loan was always paid as agreed; it was never delinquent. Before 2000, the bank had routinely granted requests for increases in the company's line of credit. West Florida President Kevin Pruitt says a Southtrust loan officer from Orlando had worked out the details of this loan several years earlier because Southtrust loan officers in Fort Myers were not familiar with asset-based lending.

In 2000, West Florida received an opportunity to expand its business substantially. Since this would require another increase in its line of credit beyond the $3

[19] "Florida National Bank Loan Policy Manual," July 1987, amended March 1989, Section 200, General Credit Policy, pp. 7–8, and Section 600, Commercial Lending, p. 2.

[20] This discussion is based on conversations with Kevin Pruitt, President of West Florida Truck Brokers; conversations with an attorney for West Florida; the complaint; and other case documents.

Table 2: Selected Financial Data – West Florida Truck Brokers

	Net Worth	Net Income	Revenues
(end of year)			
1999	$533,202	$141,141	$27,981,201
2000	795,752	262,548	32,719,739
2001	1,045,137	145,269	57,722,050
2002	918,955	−126,183	47,032,421

NOTE: All net income was retained in the business over this period. The overdraft fees are reflected in net income and net worth in 2002.

million then available, the borrower contacted Southtrust and discussed the matter with their loan officer, West, who initially indicated that an increase should not be a problem. Southtrust, however, failed to grant the requested increase in the line of credit and instead quickly placed the loan in the Special Assets department.

In Special Assets the company had to deal with a new loan officer, Tomme. Tomme began to treat West Florida much differently. Pruitt later learned that the term Special Assets was banking terminology for collections and problem loans. It soon became apparent that Tomme was not really a loan officer; his focus was solely on collecting the loan.

Tomme caused the firm to be charged over $750,000 in overdraft fees between October 2000 and December 2002. These fees were discretionary according to Southtrust policy, and in the past the bank had routinely waived overdraft fees. After October 2000 the bank refused to do this. When Pruitt inquired and protested, several bank officers told him “they want you gone”. The same sources later told West Florida that the bank had made a decision to stop lending in the trucking industry. The reasons for this decision were not revealed, but consistent with the argument elsewhere in this paper, they would appear to be linked to a desire to position a bank for merger and to the eventual merger of Southtrust and Wachovia in 2004. No one at Southtrust made any effort to assist West Florida in securing the required increase in its line of credit from another bank.

The bank acted at the time in such a way as to lead West Florida officers to believe Southtrust would call the loan. Pruitt and others at West Florida felt that if this happened it would place severe financial strains on the company and might well cause it to fail. These suggestions endangered the orderly operation of the business. The firm lost at least one key employee and several million dollars worth of sales associated with that employee.

The net worth, net income and revenues of West Florida Truck Brokers from 1999 to 2002 are shown in Table 2.

West Florida financial statements suggest quite a strong financial position, especially prior to imposition of the overdraft fees. Return on equity exceeds 50% ($262.5/533.2) in the year 2000, probably among the leading small businesses nationwide. Net worth was growing substantially with high earnings retained in the business.

The drop in sales revenues in the year 2002 is consistent with increased financial pressure on the firm, the loss of a key employee, and the associated sales, and diversion of management's time to fighting fires due to a shortage of credit. The loss in the year 2002 is due to the overdraft fees.

Financial problems are cumulative; once incurred they are often very difficult to reverse. West Florida could withstand the financial pressure, both the $750,000 of overdraft fees and the loss of credit, only because of its strong capital position. A firm with a lower net worth position would have failed, as in the case of Warehouse Wicker.

West Florida approached several other lenders over this period. Its overdraft fees, and its characterization as a Special Asset caused other lenders, such as Bank of America, to back away from loan commitments to West Florida. Bank of America's officers did question Southtrust imposition of overdraft fees. These officers didn't understand why Southtrust would place the firm in a cash flow squeeze during a period of rapid growth. BOA officers stated that Southtrust's actions were not normal banking practice, but on the contrary, highly unusual.

When it did establish a new relationship, West Florida paid an extra two percentage points on a loan with Associates/Citibank. The extra interest amounts to an additional $80,000 per year (two percentage points times an estimated average loan balance of $4,000,000). This is consistent with studies such as Berger and Udell (1995) showing that new loans are associated with higher interest rates than long-standing relationships.

At one point Tomme came to West Florida's office and threatened not to honor checks West Florida had written to Comdata. Comdata provided West Florida with vital financing for gasoline for their truckers while goods are in shipment. The goods shipped by West Florida are highly perishable and the company had several hundred trucks on the road at a given time. Pruitt told Tomme that the result would be over one quarter of a million dollars worth of produce sitting worthless on the highway. Southtrust ultimately honored the checks, which would seem to indicate that he understood the impact his actions might have on the company.

This confrontation and others, as well as the financial strain on the business, applications to other lenders, and other issues related to the unsatisfactory banking relationship produced a severe drain on management's time.

At one point, two West Florida employees personally borrowed $100,000 each and lent it to the company to help relieve the financial stress. West Florida interpreted this as an indication of the faith of employees, the people most closely associated with the daily operation of a business, in the future of the business and the way the company was being managed. Pruitt planned to contrast these actions with those of the bank in court.

The case became more personal when Southtrust involved other family members. One bank officer contacted Pruitt's aunt, someone not directly involved in the day-to-day operation of the business, and made statements causing her to believe that her funds were at serious risk in the business.

Postscript. Toward the end of the relationship, a former Southtrust president apologized to Pruitt for the way the bank had handled the entire matter.[21] About a year later Southtrust Bank merged with First Union.

With the loss of its key personnel, and in the face of ongoing financial problems stemming from the overdraft fees, Pruitt subsequently closed the business and took a position in an unrelated industry. Southtrust destroyed a business with about one million in net worth. Pruitt has moved cautiously in pursuing the litigation because of the cost and the anticipated defense tactics. The case may never go to trial.

VII. ONYX INSURANCE[22]

Southtrust Bank vs. Onyx Insurance Group (Miami-Dade County, Florida, 2002). This case is significant in and of itself but it also reveals the motivation for the same bank's actions in the West Florida case. According to counsel, an (untranscribed) deposition of Southtrust Vice President and loan officer, Romzick, indicated that the bank was closing its commercial loan department in South Florida because of the pending merger with First Union.

Fraynd, an Onyx principal, describes the conflict between Onyx and Southtrust as follows: Onyx executed a $1.5 million promissory note with the bank in December 1999, personally guaranteed by Fraynd. Southtrust promised Onyx it would provide "guidance, expertise and business advice" to foster the growth in Onyx's insurance business. Acting on the promise of liberal credit terms, Onyx also moved $3.6 million of escrow accounts to South Trust in early 2001. Onyx fully met all its obligations under the loan agreement. The loan was never in default at any time.

Southtrust did not insist on strict compliance with the financial disclosure requirements of the loan agreement until a confidential discussion between Onyx and Romzick in January 2002. Onyx revealed it was experiencing a substantial increase in false insurance claims and had problems with its reinsurance that triggered liquidity pressures, and it would thus require additional financing. At this point Southtrust insisted on immediate and strict compliance with all the reporting requirements of the loan agreement.

Onyx asserts that Southtrust knew it would be impossible for Onyx to produce the information requested in the time allowed. In attempting to comply with these requirements, Onyz provided substantial additional documentation, but Southtrust declared a "technical default" on the loan and demanded immediate repayment.

[21] In 2004, reflecting on the previous loan history, the Citibank/Associates officer responsible for the West Florida loan at the time commented to Pruitt, "it's not in our best interest for you to fail." Pruitt found this to be a notable contrast with Southtrust's attitude.

[22] This discussion is based on the affidavit of Saul Fraynd filed in this case as well as conversations with the attorney for Onyx Insurance.

Southtrust informed other Onyx creditors that the company was experiencing financial difficulties, and that it planned to sue Onyx under its loan agreement. These actions triggered claims of default by all Onyx's creditors, precipitating the insolvency of Onyx's business. Fraynd claims he and the other principals lost approximately $12 million in shareholders' equity in the business. These actions triggered a counterclaim for wrongful acceleration, bad faith, breach of fiduciary duty, breach of the loan contract, and constructive fraud. The case was never pursued in the courts, and Southtrust failed to collect on its $1.5 million loan.

While the reinsurance issues are problematic, it is clear that the bank failed to follow basic and well accepted loan workout policies summarized in Appendix II.

VIII. AMBROSIA COAL

Ambrosia Coal and Construction Company v. People's Bank of Western Pennsylvania (Lawrence County, Pennsylvania, 1996). Ambrosia sued its bank in July 1996 for breach of contract, breach of fiduciary duty, breach of the duty of good faith, conversion, violation of the Uniform Commercial Code, negligence, intentional interference with contractual relationships, and fraudulent misrepresentation, in connection with $6 million of bank certificates of deposit that plaintiffs had pledged to People's Bank. The bank had agreed to hold the CDs as collateral for construction loans, but they liquidated them in 1992, and paid off the loans with the proceeds. Ambrosia argued that the CDs were improperly liquidated and that this action damaged both the company's profits and its credit and financial position, preventing it from meeting its surety bond requirements to insurers.

This case directly makes the precise argument that I advance. The plaintiffs alleged that the only reason the bank liquidated the CDs and paid off the loans was to improve its balance sheet and financial position in preparation for a proposed merger with Bank and Trust Financial Corporation of Johnstown, Pennsylvania (B&T). The court found the argument of a link between the merger and a reduction in credit availability to be persuasive.

An April 2002 decision of the Common Pleas Court of Lawrence County, Pennsylvania entered sanctions against the bank for "willfully and purposefully failing to respond to plaintiff's document requests, thereby obstructing the development of plaintiff's case and preventing it from moving forward . . . The court found that by continually withholding the board minutes containing the information vital to plaintiff's claims, defendants delayed plaintiff's case from going to trial and deliberately placed evidence beyond plaintiff's reach. Moreover, the evidence withheld was crucial to plaintiff's case in that it could demonstrate a motivating factor for defendants' conduct."[23] The court also considered that the bank's conduct prevented plaintiffs from fully deposing witnesses who might have had information crucial to plaintiffs' claims. Moreover, this prejudice could not be

[23] Ambrosia, pp. 1–2. The court also commented that "defendant's actions essentially attempted to stonewall plaintiffs' case" (p. 5).

cured since two of the witnesses had died. Because the court found that defendants' conduct amounted to willful and bad faith behavior . . . it held that that the entry of a default judgment against the bank was warranted.

The documents at issue were minutes of meetings of the Board of Directors of People's Bank when the merger was discussed, as well as handwritten notes on these meetings made by the corporate secretary and personal secretary to the Bank President. The plaintiffs argued that the minutes would show B&T was in the process of buying People's Bank and that the merger was a motivating factor in the liquidation of Ambrosia's CDs. They further argued that the minutes would show that discussions and negotiations about the merger were taking place at this precise time, September 1992.

The plaintiffs made four requests for documents, first in October 1996; thus the bank had failed to produce the requested documents for about five and a half years before entry of the default judgment.[24] The court had earlier granted two other requests for sanctions against defendants' counsel on other matters. The link between the documents and the plaintiffs' case was so important to the case that it was the entire basis for the third motion for sanctions.

The court concluded that "defendants' failure to appropriately respond to plaintiffs' discovery requests delayed the case and prevented plaintiffs from further discovery (of) information vital to plaintiffs' cause of action. The court finds this discovery infraction to be egregious."[25] At another point it noted "the court concludes that defendants' conduct in continuing to withhold board minutes, which they knew or should have known were available and relevant to the instant litigation, exacerbated by defendants' past behavior which caused two sanction orders to be imposed against them, amounted to willful and bad faith behavior by defendants regarding plaintiffs' discovery requests."[26]

"The court finds that the withholding of information contained in the board minutes prejudiced the plaintiffs by hindering their discovery and causing plaintiffs to lose the opportunity to depose two key witnesses regarding the B&T merger. The court further finds that such prejudice cannot be cured because the two witnesses are now deceased . . . . The evidence and information that was withheld regarding the B&T merger and other issues involved in plaintiffs' case is crucial to plaintiffs in that it attempts to show a motivating factor for defendants' conduct in liquidating plaintiffs' CDs. Two witnesses with firsthand knowledge of the B&T merger passed away prior to plaintiffs becoming aware of the importance

[24] The plaintiffs requested 30 sets of board minutes. They argued that the defendants produced only 16 $\frac{1}{2}$ sets and none of these included any information about the merger. Defendants contend that the plaintiffs' counsel had visited the bank's board room in New Castle, Pennsylvania, in 1996 to review documents and to identify those being requested. However, Ambrosia's attorney testified that he never visited the bank, and the attorney's time records reveal no visit to the bank. No one from the Bank could testify that they had seen the attorney at the bank or in the board room or that there was any documentation about a visit. The court thus found no evidence to suggest that this alleged visit ever occurred.

[25] Ambrosia, p. 5.

[26] Ambrosia, p. 6.

of the merger in connection with the liquidation of plaintiffs' CDs and having an opportunity to depose the witnesses. Moreover, plaintiffs' case would not have been delayed had the board minutes been produced when requested and plaintiffs would have had the opportunity to fully develop their causes of action, particularly by deposing James Dunlevey and Nelson Young, crucial witnesses to the B&T merger. By precluding this evidence, defendants obstructed the development of plaintiffs' case, thereby preventing it from moving forward"[27]

While the court noted that its discretion to enter a default judgment should be only exercised in rare circumstances, it granted such a judgment to the plaintiffs on the liability issues, and another trial was set for damages. (In a default judgment, the court decides the liability issues in favor of one party without a trial.)

IX. GULF COMPONENTS

Wachovia Bank, NA, v. Gulf Components, Inc., Counterclaim (Broward County, Florida, 2003). Gulf started business in 1985 as a distributor of and broker for industrial electronic components. The firm is located in Fort Lauderdale, Florida, and had annual revenues totaling approximately $12 million in the years before the events of this case took place. It was a sophisticated company with a sales force fluent in 15 languages. Much of its business was tied to the aircraft industry. Among its customers were the U.S. Department of Defense and the Israeli military. Many customers are large manufacturers of electronic devices used in aerospace, communications, and computers. Sales growth had been substantial through 2000.

Before 2000 Gulf had a banking relationship with Colonial Bank. In that year, a First Union officer, Gilchrist, actively solicited the Gulf account and promised to help the firm grow its business. Gulf thus moved its loan and deposit business to First Union and paid off its old loans. The largest and most important First Union loan was a $2 million revolving credit facility and security agreement secured by Gulf's 40,000-square-foot office building in Fort Lauderdale, valued at approximately $5 million. The loan was set up to be amortized over only nine years, because the firm's CEO, Raney, wanted to allow the firm to build up equity quickly to enhance its financial flexibility. Several smaller loans included a working capital loan. All the loans were cross-collateralized, so a default on one loan would trigger a default on the others. In this way the office building effectively secured all the loans and became the central collateral item in the loan relationship.

Raney says that the loan was "out of ratio" from the moment it was made, but that First Union was not concerned about what it considered to be a purely technical violation of the loan covenants because Gulf had substantial equity in the building. When First Union merged with Wachovia, this perspective changed dramatically.

One important item in the financing package was an interest rate swap. Normally, if a firm wants a fixed interest rate on a loan, a bank will enter into a swap as the

[27] Ambrosia, page 6.

fixed- rate payer so it can make the loan at a fixed rate without incurring interest rate risk. In this case, the bank enters into the swap itself (paying fixed and receiving floating) and lends to the firm at a fixed rate of interest. Large banking institutions, such as First Union, frequently follow this approach. Then the swap is on the bank's books, rather than on the books of the small firm. Swaps require technical expertise, so the typical approach is for the bank to enter into the swap, rather than advise a small business customer to do it directly.

Gulf's case was different. First Union lent the funds to Gulf at a variable rate, and then advised Gulf to enter the swap to convert the variable rate to a fixed rate. First Union acted as a broker only. The swap was an amortizing swap, with the notional principal balance set to match the declining principal balance on the loan. The fixed interest rate was 9.79%. First Union never advised Gulf that entering into the swap would risk a swap termination fee if interest rates were to decline.

After September 11, 2001, many firms dependent on the aircraft industry suffered temporary but sharp declines in sales, and Gulf was no exception. Its sales declines were aggravated moreover by the recession in the national economy. Gulf was never late in its payments on the real estate loan, but it did fall several months behind in its payments on the other loans. At the same time, First Union was involved in a merger with Wachovia.

Because the loan had violated certain loan covenants from the moment it went on the books, Gilchrist immediately transferred the loan to Special Assets after the merger. The Special Assets officers quickly forced Gulf to repay the loan by threatening to foreclose on the building. They also swept the firm's bank accounts, making it impossible for the firm to make its payroll. Gulf's attorney has noted that Gilchrist's actions appear to reflect an obvious attempt to avoid criticism from her new supervisors for making a loan that was in violation of the covenants from the first day that it went on the books.

Raney argues that the $5 million building provided First Union adequate security for a loan that had been paid down to about $1.67 million when the bank forced repayment. A former banker himself, he was very familiar with loan workouts and requested an extension of time to bring his payments up to date. With the prospective merger partners engaged in due diligence on the loan portfolio, the normal banking practice of granting additional time or developing a formal loan workout was not an option for the loan officers. Inexplicably, the Special Assets officers refused to allow Raney to borrow funds to cure the deficiency with a second mortgage from another lender. A second mortgage would not have impaired Wachovia's position on the first mortgage. As a result, the firm had to refinance the building completely and pay off the Wachovia loan.

Unlike the other small firms profiled here, Gulf was able to secure alternative funding, albeit at significant cost. Because it had substantial equity in the building securing the loan, Gulf was able to obtain a loan with another lender, Landmark Bank, secured again by the equity in the building. At closing, however, the firm had to pay several hundred thousand dollars for a loan brokerage fee and closing costs as well as an interest rate swap termination fee of $254,100.

The swap was tied to the first bank loan; when the loan was repaid, the swap had to be terminated as well. The swap termination fee was, in effect, a prepayment penalty. Gulf was the fixed-rate payer on the swap. Gulf had locked in a fixed interest rate of 9.79% in May 2000. Since interest rates had declined substantially in the interim, it was able to refinance at a lower rate of 7.75%. Yet, contrary to the provisions of the standard International Swap and Derivatives Association Master Agreement that governed the transaction, no documentation or explanation was provided as to the calculation of the quarter of a million dollar termination fee. The bank simply added $254,100 to the principal balance due on the Wachovia loan on the closing statement and listed it in a footnote.

The cash flow and resulting reputation effects of these events were severe. Gulf's Raney commented that he had paid about $400,000 in closing costs on the Landmark loan to receive a net amount of only about $100,000 at closing, plus repayment of the Wachovia loan. The firm lost several key salespeople and other personnel during this period. Sales dropped to about $1million, well below the firm's breakeven point. One loan remained outstanding, so Wachovia maintained a lien on all of Gulf's receivables, preventing it from obtaining standard working capital financing. A few years later Gulf refinanced its building again to raise cash, incurring additional unnecessary cost.

When Wachovia sued Gulf on the one remaining unpaid loan, Gulf filed a lender liability countersuit alleging: breach of fiduciary duty (since Gulf entered the swap upon First Union's advice); breach of contract (in connection with the swap agreement and the termination fee); conversion (sweeping the accounts without providing a record of where the funds were applied); and breach of the covenant of good faith and fair dealing.

Gulf's attorney repeatedly petitioned the Court to order Wachovia to provide an accounting so that Gulf would know how much of the money that was swept from the accounts was applied to principal and interest. Five years later, no accounting of the swept funds has ever been provided and none appears forthcoming.

X. BUSY BEE

Busy Bee, Inc., Bernard Levy et al. v. Wachovia National Bank, NA. (Lackawanna County, Pa., 1996). On February 28, 2006, Judge J. Nealon of the Court of Common Pleas of Lackawanna County, Pennsylvania, released a 73-page opinion upholding a $17.3 million jury verdict against Wachovia Bank, successor by merger to Corestates Bank. The case involved a three-week trial on the liability issues in September 2004 and a separate two-week damages trial in May 2005, after which Wachovia filed a motion for post-trial relief.

In denying the motion, the judge drew heavily on the trial transcript and the opinion thus provides both a rich and detailed summary of the facts of the case and the rationale for the jury verdict, elements often unavailable in lender liability cases associated with bank mergers. The judge concluded that "the evidence was sufficient to support the jury's findings of contractual and fiduciary breaches, fraud and negligent misrepresentation, and the jury's compensatory and punitive damages awards".[28] He also found "the record established that the defendant engaged in tortious conduct".[29]

Busy Bee and its related companies were the successors to a Scranton, Pennsylvania, shoe business originally founded by the plaintiffs' grandfather in 1888. One of the named plaintiffs is BLS Associates, also known as B. Levy and Sons which is a general partnership of four firms owned by the four grandsons. Benjamin and Bernard Levy, two of the grandsons involved in the business died during the litigation.[30] Following the court, we refer to the plaintiffs as B. Levy.

A central theme at trial was the plaintiffs' argument that Corestates lacked a commitment to local Scranton-based businesses. In their dealings with the bank after the merger, they found few local people serving as loan officers. These concerns were well founded. Rather than recognizing the value to the bank of a large, profitable, well established and creditworthy local customer, the loan officer, Frank Heston, and other Bank credit officers soon took steps to force B. Levy into bankruptcy.

Evidence presented at trial indicated that during the first half of the twentieth century, virtually all shoes sold in the United States were manufactured here, but in the 1990s 95% of shoes sold in the U.S. were manufactured abroad. Foreign shoe manufacturers require the backing of American wholesale orders by letters of credit from a bank to guarantee payment. B. Levy's wholesale operation relied heavily on such letters of credit. B. Levy was a wholesale supplier of shoes for Victoria's Secret, Spiegel, Nordstrom, Bloomingdale's, T.J. Maxx, and other large catalog stores and chain retailers.

As B. Levy would not receive payment from the retailer until several months after it had paid for the merchandise, it also depended on a revolving line of credit with a bank to purchase inventory, pay its employees, and operate its retail stores. For a number of years the firm had a banking relationship with Northeastern Bank of Pennsylvania, acquired by PNC Bank in 1991. B. Levy then moved its business to Third National Bank and Trust Company of Scranton "since it preferred to do business with a local bank, and its former account representative at Northeastern Bank, Thomas Tulaney, had joined Third National Bank." A few years later, Corestates bought Third National Bank. Tulaney left the bank at that time, and Frank Heston became responsible for the Levys' business.

Heston and other bank credit officers soon took steps to force B. Levy into bankruptcy. Since the firm had adequate assets to repay the loans, this action would serve to eliminate the loan from the Corestates balance sheet.

During 1995 the Levys had been restructuring their retail operations to improve profitability. Evidence presented at trial suggested that these efforts had been successful and that Corestates, through the loan officer, Heston, had initially endorsed

[28] Busy Bee, p. 1.
[29] Busy Bee, p. 2.
[30] As noted below, both of these plaintiffs passed away during the course of the litigation.

these activities. In August 1995, Corestates renewed the Levys' $6.5 million loan "for working capital and letters of credit."[31] Then, in December 1995 Heston arranged a meeting between the Levys and senior bank management. Corestates senior credit officer, Robert Spencer, told the Levys that (in the judge's words): "In order for the Bank to continue to provide letters of credit for B. Levy's profitable wholesale business, B. Levy would have to liquidate its retail business."[32]

The trial record describes the Levy family as "stunned".[33] Despite the seriousness of the matter, the Bank gave them only two weeks to make a decision. Ultimately, they complied "to ensure the bank's continued financing of B. Levy's wholesale operation".[34] Yet, "unbeknownst to B. Levy, the bank was already preparing to terminate B. Levy's credit facility prior to its scheduled expiration date of May 30, 1996."[35] An internal memorandum authored by Heston on December 27, 1995, sets forth a detailed liquidation analysis of B. Levy's retail business and estimates the amount of money the bank could expect to receive if B. Levy was (sic) liquidated in bankruptcy. Heston expressly states in his memo that the Bank 'would then look to exit, preferably prior to the [credit] facility's 5/31/96 expiration.' "[36]

The parties met again on January 12, 1996, and the Levy's "informed Heston that the Levys had agreed to begin the liquidation process in exchange for the Bank's promise to continue is financing for B. Levy's wholesale business. Heston was pleased with the Levys' decision, advised them that he supported it, and congratulated them for making the 'right decision'. Heston's internal memorandum regarding that meeting indicates that "[i]t was obvious that [the Levys'] put a lot of thought and had to cast aside very strong feelings for the retail business in arriving at this decision."[37]

The Bank then forced B. Levy to hire a liquidation consultant of its choosing but "at no time did the Bank remotely suggest that it would suspend or terminate B. Levy's line of credit or letters of credit if the Levy's liquidated the retail business. To the contrary, the Bank represented to the Levys that it would finance B. Levy's wholesale division throughout the entire retail liquidation which would conclude at the end of 1996."[38] Privately, however, on February 6 Heston referred B. Levy's file to outside counsel for a review, presumably to begin the process of foreclosure. In early 1996 the Bank had started to require additional financial reports from the

[31] Busy Bee, p. 6.
[32] Busy Bee, p. 6. While this whole series of events may seem implausible to banking professionals, the various meetings, internal memoranda, and correspondence are documented in detail in Judge Nealon's summary, pages 4–9. Unfortunately, there is no discussion in the judge's summary of any pressure from lending personnel at Corestates headquarters in Philadelphia or any motivation behind the request to liquidate a profitable business.
[33] Busy Bee, p. 7.
[34] Busy Bee, p. 7.
[35] Busy Bee, p. 7.
[36] Busy Bee, p. 7.
[37] Busy Bee, p. 7.
[38] Busy Bee, p. 7–8.

Levys that were quite different from what it had demanded before. The rationale, as the Levys charged later, was that the bank could plan how it would seize assets in bankruptcy.

By February 20, 1996 “the Bank knew that B. Levy had cancelled [$3 million of] retail orders, terminated its retail store leases by paying penalties in excess of $100,000, and informed more than 370 employees that they would no longer have jobs. In addition, B. Levy had already closed its full service retail stores . . . and had mailed more than 100,000 flyers advertising the impending sale of its retail inventory and announcing the closing of its retail stores. B. Levy also initiated the process of terminating its employees’ retirement plan by selling the plan’s assets to make payments and distributions to the retail store employees.”[39] It had also paid the liquidation consultant recommended by the Bank over $100,000 in consulting fees.

On February 29, 1996, the Bank sent a letter to B. Levy indicating the Levys were “in default of your obligations to the Bank under the loan documents . . . as a result of, inter alia, your plans to liquidate your retail operations . . . . [A]s a result of the default, the Bank is no longer obligated to make further advances under the line of credit, and has the right to decline any requests for the issuance, renewal or extension of letters of credit”. The judge states that: “it is undisputed that during the 49 day period between January 12, 1996 (i.e., the date the Levy’s submitted their retail liquidation plan to the Bank in response to its demand on December 22, 1995) and February 29, 1996 (i.e., the date of the declaration of default), the Bank never suggested to the Levys that it did not support the retail liquidation plan, nor did it advise B. Levy that it might default the Levys or discontinue their financing for announcing or implementing such a plan. The bank likewise never suggested to B. Levy that it should reconsider its retail liquidation plan or discontinue its implementation of it. Rather, the Bank waited 49 days before notifying the Levys that B. Levy’s retail liquidation plan allegedly constituted a non-monetary default resulting in the discontinuance of B. Levy’s ability to borrow money or obtain letters of credit.”[40]

The bank’s loan agreement required that such a letter be sent by certified mail. The letter was prepared by outside counsel, Lesser, and the Bank instructed Lesser to send the letter by regular mail, so it did not arrive at the Levys’ business until Monday, March 3. The Judge states that the bank knew B. Levy’s retail liquidation sale would begin on Saturday, March 1, so “it intentionally forwarded a default notice by ordinary mail such that it was not delivered to the Levy’s until after the retail liquidation sale had already commenced.”[41]

B. Levy was completely current on its loan obligations to Corestates at this time. In fact, they had made an early payment of more than $1 million on one of the loans. The only reason that a default was declared was the liquidation, which the Bank

[39] Busy Bee, page 8.
[40] Busy Bee, p. 9.
[41] Busy Bee, p. 9.

itself had initiated and supported. Heston invoked language in the $6.5 million loan agreement defining "events of default" as including voluntary liquidation of part or all of the business to allow the Bank to liquidate the company's wholesale business.

The judge described the Levys as "shocked" and "upset"[42] by the letter. The wholesale business was extremely profitable with a gross profit (sales less cost of goods sold) of about $1.6 million per year at this time, according to the Bank's internal memoranda.

With the default declaration, the firm lost its ability to secure letters of credit and could no longer place orders with foreign manufacturers. The Levys' position, which the Court accepted, was that the default was a "sham default"[43] that allowed the bank to seize the retail assets and collateral.

After the bank declared the default on February 29, 1996, the B. Levy loan was transferred to Thomas Young in the Corestates' Special Assets Department, banking terminology for collections. Young informed the Levys that "the Bank will no longer exchange credit information"[44] on the firm and if the bank were contacted as a source of credit information it would refuse such a request. As a result, the firm could no longer obtain credit from any lender and its ability to obtain letters of credit for its wholesale business was eliminated.

B. Levy made repeated requests for letters of credit from Corestates in March 1996, but the requests were all denied. The firm contacted both Mellon Bank and PNC Bank about financing, but as Corestates insisted on a first lien on any receivables to be generated, these efforts were unsuccessful. (The same bank used the same tactic in the Gulf Components case.) The firm went into bankruptcy on July 25, 1996.

Two of the Levy brothers, grandsons of the founder, died soon after these events, one in 1997 and one in 1998. The judge's opinion does not indicate whether the emotional stress of the loss of the family business and the lawsuit were considered contributing factors.

The plaintiffs' attorney told the jury that B. Levy had spent over $1 million in bringing the case to trial. He showed the jury a 1910 picture of the B. Levy Store at 305 Penn Avenue in Scranton and a January 8, 1932, letter memorializing B. Levy's efforts to assist other Scranton businesses during the Depression. B. Levy argued during trial that, although the firm "survived the Great Depression, two World Wars and numerous recessions and economic cycles during its 108 year history, it could not withstand the wrongful actions of the Bank which destroyed B. Levy's wholesale and retail shoe businesses"[45]

The $17.3 million jury verdict amounted to only half of the economic damages estimated by the Levys' expert witness.

[42] Busy Bee, p. 10.
[43] Busy Bee, p. 10.
[44] Busy Bee, p. 11.
[45] Busy Bee v. Wachovia, p. 4.

Table 3: Small Business Loan Ratios: Wachovia and First Union –Before and after the Merger

	Wachovia			First Union		
	Total Small Business Loans	Total Lease and Loans	% of Small Business Loans to Total Loans and Leases	Total Small Business Loans	Total Lease and Loans	% of Small Business Loans to total Loans and Leases
1998	10,395,006	132,193,510	7.86%	**6,623**	**48,711**	**13.60%**
1999	8,391,000	128,230,000	6.54%	117,246	756,539	15.50%
1999 (Proforma)	**8,508,246**	128,986,539	6.60%			
2000	**7,951,000**	136,281,000	5.83%			
2001	7,729,012	124,566,000	6.20%			
2002	12,338,019	162,028,000	7.61%			
2003	11,793,019	161,029,000	7.32%			
2004	11,806,019	177,002,000	6.67%			
2005	17,283,019	232,037,000	7.45%			
2006	16,636,019	274,595,000	6.06%			

XI. HOW SHOULD BANK REGULATORS RESPOND?

Prompted by concerns as to the future of small-business lending in the face of bank consolidation, in 1993 federal bank regulators began to ask commercial banks to report their outstanding small business loans. These data are shown only in the June call report. The data in Tables 3–5 are taken from the website of the Federal Deposit Insurance Corporation (www.fdic.gov), which provides call reports for all commercial banks beginning in 1998. The reports include the size of the loan, line of credit, or loan commitment for all commercial and industrial loans with original amounts[46] of $1 million and under that are currently outstanding as of June 30 and not secured by single-family residences. They also include farm loans with original amounts of $500,000 and less. These figures understate small business lending because many small-business loans involve original amounts of over one million dollars (e.g., the loan amount in *Busy Bee* was approximately $7 million) and some are secured by single-family residences.

Five of the six cases I have discussed involve Wachovia, First Union or their predecessors – Corestates and Southtrust. Wachovia and First Union merged in 1999; First Union was arguably the surviving institution, but the new bank took the name Wachovia. I compiled data on the ratio of small-business loans to total loans for these institutions and their predecessors to determine if the pattern evident in

[46] If the amount outstanding exceeds the most recently approved line of credit or loan commitment, the amount outstanding is reported.

Table 4: Small Business Loan Ratios: Wachovia and South Trust Before and After the Merger

	Wachovia			SouthTrust		
	Total Small Business Loans	Total Lease and Loans	% of Small Business Loans to Total Loans and Leases	Total Small Business Loans	Total Lease and Loans	% of Small Business Loans to Total Loans and Leases
1998	10,395,006	132,193,510	7.86%	4,611,694	25,258,141	18.26%
1999	8,391,000	128,230,000	6.54%	4,620,984	29,487,732	15.67%
2000	7,951,000	136,281,000	5.83%	4,618,104	32,398,747	14.25%
2001	7,729,012	124,566,000	6.20%	5,406,864	32,771,054	16.50%
2002	12,338,019	162,028,000	7.61%	5,687,472	33,735,265	16.86%
2003	11,793,019	161,029,000	7.32%	5,740,284	35,678,691	16.09%
2004	11,806,019	177,002,000	6.67%	5,730,270	37,268,089	15.38%
2004 (Proforma)	**17,536,289**	214,270,089	8.18%			
2005	**17,283,019**	232,037,000	7.45%			
2006	16,636,019	274,595,000	6.06%			

the lender liability cases is also present in data for the banks as a whole. The data strongly support a conclusion that these five lender liability cases involving this Bank are more than just random occurrences.

As Table 3 indicates, First Union had a much higher ratio of small-business loans to total loans than Wachovia prior to the merger. (The figure of 15.5% for First Union for 1999 is actually much higher than comparable figures for other large banks for later years, as Table 4, to be discussed below, will show.) Clearly, with the benefit of hindsight, this was not a good merger in terms of its impact on small business lending. The data suggest other small businesses likely suffered besides those I have discussed.

After the merger, we can see that the combination itself actually contributed to an immediate drop in small business lending. The 1999 pro forma figures in Table 3 reflect the combined balance sheet of the two institutions before the merger. These data reveal small business loans outstanding of $8.5 billion on June 30, 1999. A year later the figure reported for the combined institution is slightly under $8 billion, a decline of 6.55% (based on unrounded numbers). This drop occurred despite an increase in total lending from $129 to $136 billion in the same period. Furthermore, the ratio for Wachovia remained in the 6.0% % to 7.6% range through 2006.

Of course, some of the drop in small business lending was no doubt the result of customer decisions, as borrowers not happy with the new institution gradually found other lenders, or followed their former loan officers to other banks. Even so, this indicates dissatisfaction in the business community with the level and quality of service provided to small firms, and the bank's commitment to small business.

Table 5: Small Business Loan Ratios at Large Commercial Banks

	Total Assets (Thousands of Dollars)		
Commercial Bank	2004	2005	2006
Bank of America	706,888,184	1,047,545,743	1,160,260,442
JPMorgan Chase Bank	654,641,000	973,113,000	1,144,680,000
Citibank	648,243,000	704,855,000	777,345,000
Wachovia Bank	368,871,000	459,529,000	504,270,000
Wells Fargo Bank	364,698,000	364,120,000	415,859,000
U.S. Bank	189,736,629	203,477,573	212,553,949
SunTrust Bank	125,922,072	167,395,304	181,442,168
The Bank of New York	94,536,383	86,079,000	93,863,000
State Street Bank	90,895,554	91,915,164	89,692,165
Branch Banking and Trust	74,906,064	76,719,103	85,214,955
Keybank	74,847,093	86,504,869	90,534,912
PNC Bank	67,526,820	82,691,094	85,946,560
LaSalle Bank NA	62,764,854	69,751,492	72,245,639
Fifth Third Bank	60,510,974	56,879,658	58,016,440
Comerica Bank	54,646,420	54,861,755	57,652,104
M&T Trust Company	51,497,358	53,955,628	55,789,617
AmSouth Bank	48,212,819	50,478,019	53,899,220
National City Bank	47,666,649	69,600,658	69,838,107
Regions Bank	46,170,713	81,820,601	81,954,710
Union Bank of California	45,841,034	50,519,153	50,054,634
Chase Bank USA	42,389,259	88,311,750	74,420,048
Bank of the West	30,812,933	41,903,968	55,634,929
North Fork Bank	25,963,401	59,766,574	58,787,682
	Total Leases and Loans (Thousands of Dollars)		
Commercial Bank	2004	2005	2006
Bank of America	339,896,759	483,553,887	581,757,448
JPMorgan Chase Bank	155,923,000	337,295,000	346,756,000
Citibank	168,757,000	169,885,000	188,701,000
Wachovia Bank	177,002,000	232,037,000	274,595,000
Wells Fargo Bank	275,091,000	281,754,000	276,819,000
U.S. Bank	120,983,349	131,483,803	140,264,507
SunTrust Bank	87,469,791	117,693,046	131,011,826
The Bank of New York	28,342,378	22,705,000	25,452,000
State Street Bank	4,680,419	5,269,869	5,778,571
Branch Banking and Trust	50,923,199	54,413,799	60,086,938
Keybank	53,063,028	66,445,718	69,830,088
PNC Bank	37,590,200	48,139,396	49,566,664
LaSalle Bank NA	35,515,678	39,460,452	43,183,610
Fifth Third Bank	31,214,465	34,230,732	36,003,286
Comerica Bank	38,563,636	41,268,218	45,230,819

(*Continued*)

Table 5: (*Continued*)

	Total Leases and Loans (Thousands of Dollars)		
M&T Trust Company	37,125,659	39,655,591	41,380,662
AmSouth Bank	31,627,416	33,868,443	37,831,731
National City Bank	40,114,967	55,462,514	55,331,249
Regions Bank	34,948,080	58,364,749	56,378,981
Union Bank of California	25,450,058	30,439,842	33,756,923
Chase Bank USA	39,471,144	65,810,775	50,624,599
Bank of the West	22,012,656	28,278,885	38,307,464
North Fork Bank	15,150,584	38,644,548	40,563,384

	Small Business Loans (Thousands of Dollars)		
Commercial Bank	2004	2005	2006
Bank of America	12,208,592	16,885,458	18,860,964
JPMorgan Chase Bank	4,687,000	14,823,000	15,175,000
Citibank	7,396,061	4,942,060	5,765,970
Wachovia Bank	11,806,019	17,283,019	16,636,019
Wells Fargo Bank	23,769,000	17,694,000	21,216,889
U.S. Bank	12,001,516	12,950,808	12,363,741
SunTrust Bank	6,682,685	8,684,909	5,898,130
The Bank of New York	1,081,152	973,900	835,900
State Street Bank	0	0	0
Branch Banking and Trust	7,460,766	7,410,107	5,697,125
Keybank	4,657,818	4,587,319	4,640,161
PNC Bank	2,425,947	2,809,343	3,117,418
LaSalle Bank NA	1,108,951	1,135,774	1,142,923
Fifth Third Bank	2,681,471	2,882,172	2,900,016
Comerica Bank	4,058,945	3,953,704	3,974,517
M&T Trust Company	4,673,410	5,641,448	5,364,567
AmSouth Bank	3,988,319	3,570,504	3,814,961
National City Bank	2,569,524	3,222,851	3,050,110
Regions Bank	7,160,679	11,493,339	11,077,103
Union Bank of California	1,794,881	2,239,042	1,929,862
Chase Bank USA	0	2,625,208	2,670,903
Bank of the West	1,472,761	2,641,304	3,153,616
North Fork Bank	1,525,420	2,886,827	5,012,215

	Percentage of Small Business Loans in Total Loans		
Commercial Bank	2004	2005	2006
Bank of America	3.59%	3.49%	3.24%
JPMorgan Chase Bank	3.01%	4.39%	4.38%
Citibank	4.38%	2.91%	3.06%
Wachovia Bank	6.67%	7.45%	6.06%
Wells Fargo Bank	8.64%	6.28%	7.66%

(*Continued*)

Table 5: (*Continued*)

	Percentage of Small Business Loans in Total Loans		
U.S. Bank	9.92%	9.85%	8.81%
SunTrust Bank	7.64%	7.38%	4.50%
The Bank of New York	3.81%	4.29%	3.28%
State Street Bank	0.00%	0.00%	0.00%
Branch Banking and Trust	14.65%	13.62%	9.48%
Keybank	8.78%	6.90%	6.64%
PNC Bank	6.45%	5.84%	6.29%
LaSalle Bank NA	3.12%	2.88%	2.65%
Fifth Third Bank	8.59%	8.42%	8.05%
Comerica Bank	10.53%	9.58%	8.79%
M&T Trust Company	12.59%	14.23%	12.96%
AmSouth Bank	12.61%	10.54%	10.08%
National City Bank	6.41%	5.81%	5.51%
Regions Bank	20.49%	19.69%	19.65%
Union Bank of California	7.05%	7.36%	5.72%
Chase Bank USA	0.00%	3.99%	5.28%
Bank of the West	6.69%	9.34%	8.23%
North Fork Bank	10.07%	7.47%	12.36%
	Percentage of Small Business Loans in Total Assets		
Commercial Bank	2004	2005	2006
Bank of America	1.73%	1.61%	1.63%
JPMorgan Chase Bank	0.72%	1.52%	1.33%
Citibank	1.14%	0.70%	0.74%
Wachovia Bank	3.20%	3.76%	3.30%
Wells Fargo Bank	6.52%	4.86%	5.10%
U.S. Bank	6.33%	6.36%	5.82%
SunTrust Bank	5.31%	5.19%	3.25%
The Bank of New York	1.14%	1.13%	0.89%
State Street Bank	0.00%	0.00%	0.00%
Branch Banking and Trust	9.96%	9.66%	6.69%
Keybank	6.22%	5.30%	5.13%
PNC Bank	3.59%	3.40%	3.63%
LaSalle Bank NA	1.77%	1.63%	1.58%
Fifth Third Bank	4.43%	5.07%	5.00%
Comerica Bank	7.43%	7.21%	6.89%
M&T Trust Company	9.08%	10.46%	9.62%
AmSouth Bank	8.27%	7.07%	7.08%
National City Bank	5.39%	4.63%	4.37%
Regions Bank	15.51%	14.05%	13.52%
Union Bank of California	3.92%	4.43%	3.86%
Chase Bank USA	0.00%	2.97%	3.59%
Bank of the West	4.78%	6.30%	5.67%
North Fork Bank	5.88%	4.83%	8.53%

Table 6: Percentiles for Ratios Shown in Table 5

	Percentage of Small Business Loans in Total Assets			Percentage of Small Business Loans in Total Loans and Leases		
	2004	*2005*	*2006*	*2004*	*2005*	*2006*
25th percentile	0.0173	0.0163	0.0163	0.0381	0.0429	0.0438
50th percentile	0.0478	0.0483	0.0437	0.0705	0.0736	0.0629
75th percentile	0.0652	0.0636	0.0669	0.1007	0.0958	0.0881
Wachovia	*0.0320*	*0.0376*	*0.0330*	*0.0667*	*0.0745*	*0.0606*

A similar pattern is evident in the 2004 Wachovia-Southtrust merger (Table 4). Southtrust maintained a small business loans to total loans ratio in the 15% to 18% range before the merger. After the merger, the ratio for the combined institution was in the 6.0% to 7.5% range. Again, after the merger, small-business loans outstanding dropped, from $17.5 to $17.3 billion.

These patterns are consistent with the prediction by Berger, *et al.* (1998) that the melding of bank balance sheets in a merger involving at least one large bank produces an economically significant static drop in small-business lending. (The effect was estimated to be a drop of $26 billion, or 16%, in their study.)

Table 5 shows similar ratios for 2004–06 for all banks with over $50 billion in assets as of June 30, 2006.[47] Also shown are the ratios of small business loans to total loans and total assets for the same institutions. Table 6 shows median, top 25th percentile and bottom 25th percentile figures for the same institutions. Wachovia ranks below the median in each year, but it is not in the bottom 25th percentile.

Some mergers would obviously have more adverse effects on small business lending than others. Tables 5 and 6 demonstrate how regulators might evaluate the impact on small business lending of a proposed merger of two large banks. Suppose Wachovia applied to merge with Regions Bank, a bank with a particularly strong commitment to small-business lending, according to the data in Table 6. Given Wachovia's history, as seen in *both* its five lender liability cases discussed here and the data shown in Tables 3 and 4, this merger should be rejected, because it would be expected to have a large negative effect on small-business lending. Note that a merger between Wachovia and Bank of the West would produce much less serious effects.

The methodology should, of course, be much more sophisticated than this simple example. Data from examination reports could be incorporated into the process to provide evidence of a bank's commitment to small business lending. Yet not even a simple analysis of the likely effect of a merger on small-business lending

[47] I show only three years of data for reasons of space and clarity. As Table 4 indicates, the ratios appear to be fairly stable from year to year.

is now conducted. Regulators' antitrust analysis does not focus on small business lending[48] and some regulatory economists even propose weakening the current antitrust approach by expanding the relevant geographic market. I return to this issue in Section XII, Part 4.

XII. FUTURE RESEARCH AND OTHER POLICY RECOMMENDATIONS

1. *Are credit cards a substitute for bank-borrower relationships?* Here's an actual television commercial:

> Big Banker A (foot on his desk), "Another day, another billion in big business loans."
> Big Banker B (obviously a subordinate), "Sir, I think there's something on your shoe."
> Small Businessman (about one one-hundredth the size of the other two characters, stuck on the shoe of Big Banker A), "Good morning. If I could just have a minute of your time?"
> Big Banker A (peering at the bottom of his shoe), "A small business owner. Ugh! Give me a pencil."
> Big Banker B (with derision), "What does *he* want, a *loan* or something?"
> Big Banker A then uses the pencil to scrape Small Businessman off his shoe and into a trash can.
> Big Banker B (peering into the trash can with Big Banker A, laughing, "Look, he's got a 'business plan.' "

The commercial ends with both bankers continuing to look at the small businessman in the wastebasket and laughing. An announcer then asks, "Does your bank think small about small business?" and notes that a well-known credit card company offers "small business" products including "business loans, lines of credit, and credit cards."

This is of interest to my theme for two reasons. First, it illustrates that the notion that large banks have little or no interest in small-business lending has become part of our popular culture. This is consistent with numerous academic studies. For example, Berger, Demsetz, and Strahan (1999) review existing studies and find a threshold effect based on asset size, in that larger banks direct most of their lending to larger firms.

Second, it suggests a question about market definition in the antitrust analysis of bank mergers.

During a panel discussion at the Federal Reserve Bank of Chicago's 2006 Annual Conference on Bank Structure and Competition, a member of the audience seriously suggested that because such credit card companies are offering cards to small business, the relevant market for small business lending is therefore now nationwide. Gregory Udell, a panelist, responded with a much more plausible

[48] Holder (1993) and Prager (2004) discuss the regulatory agency's approach to antitrust analysis but neither mentions any analysis of the effect of a merger on small business lending.

observation that for relationship loans, a product that remains of significant interest to small business, the market remains local.

The credit card company's advertising material refers to up to $20,000 offered for small business loans. This is obviously well below the $7 million loan and line of credit that was at issue in *Busy Bee v. Wachovia*, to consider just one example. It is not likely that a bank would lend several hundred thousand dollars to a firm for working capital without meeting the borrower and visiting its place of business. Nonetheless, the exchange of ideas at the conference reveals serious differences of opinion among economists on the issue of the relevant geographic market in which to analyze a bank merger. Berger, Frame and Miller (2005) find that credit scoring of small business loans is a common practice, but only up to about $250,000 at most.

I consider this question below in more detail as I discuss the way the federal regulatory agencies deal with bank mergers. To place the discussion in the context of the issues raised in this paper, I first discuss what I consider to be the lessons of my six cases.

2. *Evaluate the Implications of Lender Liability.* My six lender liability cases illustrate a clear process of value destruction following bank mergers. Yet they are only a small sample of the times a bank merger resulted in reduced small business lending with the elimination of certain loans from the balance sheet. Many empirical studies, such as Berger *et al.* (1998), find that mergers reduce lending to small firms. Researchers generally do not consider what happens to these small firms when their source of credit disappears. If a small firm is heavily dependent on credit for its existence, the effects must have been severe in many cases without an orderly transition to another bank.

My six cases include only those on which I found information from sources such as documents provided by local attorneys and searches of computerized legal databases, including both Westlaw and LexisNexis. These are the only cases in these databases that turn up in response to both key words "lender liability" or "loans" and "bank mergers." The information from the expert witness files was compiled over a long period of time.

Cases that have been settled are not included, except for the Taco Prima/Warehouse Wicker case described in Section V, because the information is not available. Also excluded are cases with jury verdicts but no judicial summary and opinion; again, these cases do not appear in the databases. (The judicial opinion in Busy Bee (Section X) was prepared in response to the bank's request for "post-trial relief," undoubtedly a step toward an appeal.)

With the exceptions noted, I exclude for lack of information cases that were either never filed or never litigated, presumably because of the expected expense involved in suing a large financial institution with virtually unlimited financial resources. It is especially difficult for a small business owner to assume these expenses when the complaint involves such difficult and emotional issues as the alleged destruction of a business. (It should be obvious that the plaintiff is simultaneously suffering serious financial damages because that same business no longer generates income.)

In fact, three of my six cases have not been litigated at the time of this writing because of the potential expense.

Scorched-earth, zealous-advocacy defense tactics are discussed in Appendix I. These are frequently used to increase the cost to the plaintiff and make him less likely to pursue the case.[49] To illustrate, it is reported in *Busy Bee* that the case cost the plaintiffs over one million dollars to litigate.

Of necessity, the paper also omits cases which cannot be readily linked to bank mergers because the plaintiff is simply not aware of the connection. Frequently and for obvious reasons, banks do not reveal the real motivation of the bank officers involved in a lender liability case. In fact, in the West Florida case described in Section VI the connection between the merger and the bank's actions was revealed only when a deposition of a loan officer in a completely different case revealed Southtrust Bank was closing its commercial lending operation in South Florida in connection with the merger. The attorney and expert witness for West Florida learned about this related case by accident.

Perhaps most important in terms of the number of cases available, there is no way to know when a small business is simply asked to take its loan business elsewhere, or becomes discouraged at the lack of attention to the needs of small business at the merged institution, or voluntarily seeks a new bank relationship. A small business owner may have had revealing previous experience with a large bank, or have learned elsewhere the way large banks treat small firms. Many firms may move their business because their loan officer moves to a new bank. There may or may not be value destruction during this process, depending on the particular circumstances.

Comprehensive summaries of lender liability by Capello and Komoreske (1993) and Budnitz (2006) list several thousand lender liability cases, most of them in the 1980s and 1990s. They do not mention bank mergers as a cause of lender liability, and neither volume lists the words, "merger" or "bank merger," in the index. Capello and Komoreske (1993) discuss in "Where Problems Arise" the most common causes of lender liability, but bank mergers are not included. Thus no previous research has attempted to link lender liability cases and bank mergers. The connection became clear to me only after I was exposed to three such cases as an expert witness and consultant.

Why would bank officers deliberately destroy value? Litigation seldom reveals the precise motivation of the loan officers involved, unless such information is specifically developed and presented by the plaintiff, because that information would likely damage a bank's case. In the six cases I discuss the connection became clear because the plaintiff, his attorney or his expert witness knew about the merger and made the connection to the case.

[49] In Gulf, the bank's attorney added years to the case timetable by filing a Motion for Summary Judgment. He then repeatedly postponed every hearing on the motion for several years, forcing the attorney for the plaintiff to continually reprepare. Eventually, these expenses became almost prohibitive for the plaintiff.

Consider that these six cases all fit the pattern described in the theory set forth at the outset. The value of repeat business to the target bank approaches zero as a merger approaches so loan officers of the target bank have no incentive to treat the small firm well. A bank officer responsible for making small business loans, which are generally characterized by the use of soft information to extend credit and monitor firm performance, knows his institution is involved in a merger with a larger institution. The larger institution is known or presumed to rely on hard information about firm performance, and to place little value on soft information.

It is reasonable to presume that career concerns, coupled with knowledge of the lending policies of the acquiring bank, might provoke the actions described here, and others at other institutions. Bank mergers typically involve considerable job losses, and loan officers are as vulnerable as anyone else. Loan officers not accustomed to operating in a manner consistent with the policies and practices of the new institution would be obvious candidates for termination. Apart from concern about job security, an officer's possible position in the new organization could motivate him or her to keep potentially controversial small-business loans off the books of the new institution. This was clearly the motivation behind the actions of the bank president in the Taco Prima/Warehouse Wicker case (Section V). It was also explicit in the Ambrosia Coal case (Section VIII) and it may well have played a role in cases such as Busy Bee (Section X).

The due diligence requirements of the merger partner no doubt also play a role. A bank with an easier-to-understand loan portfolio may be a more desirable merger partner; banks with a significant number of small-business loans characterized by unverifiable soft information may be less desirable merger targets. A bank may thus sow the seeds of lender liability as it positions itself to be acquired. Put simply, there is much more money involved in a bank merger than what can be lost in a lender liability lawsuit. Senior managers normally spend significant time and effort on a merger, and loan officers who disregard the priorities of their superiors during this time are likely to be the first on the firing line.

Furthermore, researchers on bank mergers need to take into consideration, and be able to explain, the findings of Garmaise and Moskowitz (2006) in a recent lead article in the *Journal of Finance* that there is a significant relation between bank mergers and crime in a local area. My case study results are consistent with that finding, while the results of most other studies are not, since most other researchers do not find or predict serious value destruction as a result of bank mergers.[50] If Garmaise and Moskowitz are right, the results could be serious since there were about 3,500 bank mergers in the United States during the period 1994 to 2003 (Prager (2004)).

Garmaise and Moskowitz consider the transmission mechanism between bank mergers in a local area and an increase in property crime to be a decline in bank competition, a resulting increase in loan interest rates, hence a reduction in the quantity of loans. They do not provide data on these variables, however. Further, in

[50] The exception is Carow, Kane and Nayaranan (2006).

many of the areas in their sample, such as Chicago and the entire state of California, bank markets are quite competitive, and one merger is unlikely to change this. Furthermore, Prager (2004) points out that local concentration measures have changed little over the last 20 years. This is partly because some mergers increase competition by bringing new banks into markets where they were not previously represented. Garmaise and Moskowitz do not consider this point either.

Most importantly, even with no change in competitive conditions in the local market, my analysis suggests a decline in real economic activity can result from a bank merger as banks attempt to eliminate some loans from their balance sheets, possibly damaging the borrower in the process. My analysis thus explains the Garmaise and Moskowitz results quite well. In fact, given the effect described here, their results are quite plausible – there were 3,500 bank mergers during 1994–2003, and a number of them may well have involved circumstances similar to the six cases described here.

3. *Focus Regulatory Agency Approaches to Bank Mergers on Small Business Lending*. Economists typically view bank mergers through the structure-conduct-performance paradigm. The theory begins with a smooth downward sloping demand curve for bank loans, and assumes that the objective of the bank to maximize profits. After a merger, a resulting institution that has more market power will raise loan rates and limit the quantity of loans, thus diminishing social welfare.

The appropriate approach for the regulatory authority is to determine how much of an increase in market concentration will result from the merger. Unless the increase is "significant," (Prager (2004)), the merger is considered to have no damaging economic effects and to have a potentially positive effect on efficiency. On this basis, most bank mergers, probably well over 95%, are approved.

The structure-conduct-performance effect follows directly from the standard microeconomic model of the monopoly or oligopoly firm. This model has been enshrined in antitrust analysis at the federal bank regulatory agencies since the landmark case, *U.S. v. Philadelphia National Bank,* was decided by the U.S. Supreme Court in 1963.

The effects I describe, whether or not they give rise to lender liability, may be entitled as the "loan selection effect," an effect quite different from the structure-conduct-performance effect. It does not require an assumption that demand curves for loans are smooth and downward-sloping and it does not require that banks maximize profits.[51] In fact, it is consistent with the findings of Petersen and Rajan (1994) that loan relationships have more of an effect on the quantity of credit than the price. Most important, the loan selection effect does not require that the increase in concentration be "significant." Rather it can occur with no increase in concentration, or with a decrease. If the market is competitive, a borrower can more readily find another bank and shift its business to that bank. However, as both Berger and Udell (1995) and Budnitz (2006) note, this takes considerable time,

[51] As suggested elsewhere, managers may be acting to maximize the value of their bank in a merger. This can be quite different from maximizing profits.

even in a competitive market. However, a small business loses the beneficial effect of the long-standing loan relationship and the value effects associated with bank relationships (e.g., Elysiani and Goldberg (2004)).

The loan selection effect relies on the simple notion that certain banks prefer to hold certain types of loans and not to hold other types of loans. Before or after a merger, a bank may thus take drastic action to restructure its balance sheet. We have seen that some of these restructuring efforts have given rise to serious value destruction and lender liability issues. We have already noted that the loan selection effect may explain the important results of Garmaise and Markowitz better than the structure-conduct-performance effect.

Following the logic of the structure-conduct-performance effect, regulators compute a Hirschman-Herfindahl Index (HHI) to measure competition in the market served by the disappearing bank. Because local area data is collected for deposits and not for loans, the concentration measures normally used are deposit-based. Deposit-based HHI's may not, and probably do not, reflect the local market for small-business lending.

Thus, a serious problem arises. If a merger does result in a significant increase in deposit market concentration, the regulators often simply ask the resulting institution to spin off a few branches in the affected area to avoid concentration above some critical level.[52] If the ultimate focus is small-business lending (as the Supreme Court said it was supposed to be in *Philadelphia National Bank*), and if deposit-based HHIs are just a proxy, this approach clearly has serious limitations, and in fact may make little sense at all.

It seems common sense that regulators should make a serious attempt to determine the effect of a merger on the *number of effective competitors* in the local market for small-business lending before approving a merger. Most of the data for doing this is available and bank examiners could be used to provide supplementary information. However, they do not do this. To go further, it is appropriate to consider making small business lending a distinct line of commerce for antitrust purposes.

Most studies using bank balance sheet data have found that at large banks a smaller fraction of assets is devoted to small business loans than at small banks. They conclude that in the short run bank consolidation will thus necessarily reduce small- business lending. Yet, as noted, they often go on to argue that *in the long run* these effects will be mitigated.

Berger, Saunders, Scalise and Udell (1998), for example, find a "considerable" initial decline in small business lending. After three years, this "static" effect appears to be offset by dynamic market effects. The entry of new banks and the

[52] One Federal Reserve official describes their process as allowing mergers "accompanied by divestitures that ameliorate their effects on market structure" (Prager (2004, p. 120)). Let us assume that "ameliorate" means "to partially reduce." Arguably, this approach may be inconsistent with the antitrust laws. As the U.S. Supreme Court notes in *U.S. v. Philadelphia National Bank*, the Clayton Act holds that a merger that significantly reduces competition "in any line of commerce in any section of the country" (p. 1720n) is illegal. My analysis suggests it may be appropriate to consider small-business lending as a distinct line of commerce.

reaction of established banks to the shortage in small-business credit eventually cause small-business lending to increase, notwithstanding some disruptive effects until the new banking relationships mature.

Research using bank balance sheet data cannot measure the damage to individual businesses when credit is withdrawn. Operating a business requires continuity. A small business that is without credit for three months (or maybe even three weeks in many cases), let alone three years, will not survive. Lord Keynes famous dictum that "in the long run we are all dead" is certainly relevant in this context. (In *Busy Bee*, two members of the Levy family died during the eight years it took to bring the case to trial.)

Busy Bee also illustrates continually changing banking relationships. Regulators allowed PNC Bank to acquire B.Levy's bank, Northeastern Bank of Pennsylvania, in 1991. B.Levy then followed its loan officer to The Third National Bank and Trust Company of Scranton. They lost that loan officer when the regulators allowed Corestates to acquire Third National Bank in 1994. First Union acquired Corestates and then Wachovia acquired First Union. Thus B. Levy had to deal with three different banks in a five year period (1991–1995). If it had survived, it would have had to deal with two additional banks. This would be disruptive to any small business, even in the absence of lender liability.

Certain banks prefer certain types of loans and apparently purge other types of loans from their portfolios altogether. Frieswick (2004) reports many complaints from small- and medium-sized businesses about credit availability and loss of relationships (including fewer loan officers) and resulting loss of business opportunities as a result of the Fleet-Bank-of-Boston merger.[53]

4. *Implications and Suggestions for Recent Regulatory Research.* Three recent studies by Federal Reserve economists have suggested that the relevant market for analyzing the anticompetitive effects of bank mergers is no longer local (Cetorelli and Strahan (2006), Edelstein and Morgan (2006), and Prager (2004)). This conclusion, if it were transmuted into policy, would have the effect of allowing many more bank mergers. The reasoning is based entirely on econometric studies of bank *deposit pricing* behavior or on evidence on branch prices. These studies do not consider the relevance of small-business lending in bank merger analysis. My analysis draws exactly the opposite policy implications. The theoretical discussion of the value of repeat business and of organizational structure and soft information, and the empirical evidence coming from the lender liability cases, should make it clear that any change in the regulatory agencies' approach to bank mergers that ignores local small-business loan markets would be a serious mistake.

Most small businesses have no choice beyond their local area when seeking credit. The effect of a merger on deposit interest rates is important, but it should surely be secondary to the effect on small-business lending. Even if a merger were to result in, say, a 25 basis point reduction in average deposit rates (which is highly unlikely), this would involve only a wealth transfer from depositors to

[53] Carow, Kane and Narayanan (2005, p. 3n).

bank shareholders. Distribution effects may be important politically and socially, particularly if depositors are poorer on average than bank shareholders, which seems likely. However, *there is no net welfare loss* in this case.

There is clearly a net welfare loss when the flow of small business credit is reduced or eliminated, as in my six cases and as predicted by the econometric studies I have discussed. There is a loss of real output. The effect, moreover, may be cumulative as Garmaise and Moskowitz's (2006) analysis implies. And, as noted, the effect cannot be reversed by a later increase in credit. Small businesses require a *continual and reliable* flow of credit. An unexpected decrease followed by a subsequent increase does not cancel out. In the long run we are all dead.

Consider the U. S. Supreme Court's reasoning in the *Philadelphia National Bank* case (1963):

> Banking operations are varied and complex; 'commercial banking' describes a congeries of services and credit devices. But among them the creation of additional money and credit, the management of the checking account system and the furnishing of short-term business loans would appear to be most important.[54]
>
> Banks compete to fill the credit needs of businessmen. Small businessmen especially are, as a practical matter, confined to their locality for the satisfaction of their credit needs. If the number of banks in the locality is reduced, the vigor of competition for filing the marginal small business borrower's needs is likely to diminish. At the same time, his concomitantly greater difficulty in obtaining credit is likely to put him at a disadvantage vis-a-vis the larger businesses with which he competes . . . .
>
> At the price of some repetition, we note that if the businessman is denied credit because his banking alternatives have been eliminated by mergers, the whole edifice of an entrepreneurial system is threatened; if the cost of banking services and credit are allowed to become excessive by the absence of competitive pressures, virtually all costs in our credit economy will be affected.[55]

The current regulatory preoccupation with *deposit-based* HHIs raises serious problems. It can allow banks to spin off branches in order to reduce index values to certain critical limits without any regard for the effect on the supply of small-business credit. Small- business lending is often not even conducted at the branch level.

The serious consideration given to the notion that the relevant banking market for antitrust purposes may no longer be local is based solely on banks' *deposit pricing* behavior. This idea is completely at odds with the Supreme Court's reasoning in *U.S. v. Philadelphia National Bank*. The lender liability evidence, together with the research results reported by Garmaise and Moskowitz (2006) and Carow, Kane,

[54] United States v. Philadelphia National Bank, pp. 1721–1722.

[55] *United States v. Philadelphia National Bank*, p. 1745. While much has changed in banking research in 44 years, it is interesting that some of the same concerns remain. Just as small business finance occupies a prominent place in financial research today, one of the sources considered by the Court in their decision was a report entitled "Financing Small Businesses" published by the Board of Governors of the Federal Reserve System in 1958.

and Narayanan (2005) (2006) would certainly argue for a return to an emphasis on the effect of mergers on small-business lending, which the Court eloquently emphasized in its historic *Philadelphia National Bank* decision.

Without reliable HHIs for small-business lending,[56] admittedly difficult to construct, bank regulators should consider the number of *effective* competitors in the local market for small business loans, and develop data to measure the effect of a merger on that number.

Researchers also need to evaluate the effect of bank mergers on the turnover rate of small businesses. These turnover rates are quite high and it may not be possible to develop reliable data and procedures for evaluating this issue, but the attempt should be made. For example, it should be possible to answer the following question: Of the small firms that existed in a survey at time A, how many survived until time B? Did the fact that a firm's bank was involved in a merger have any effect on the survival rate?

5. *Clarify and Expand the Role of Bank Examiners in Evaluating Lender Liability Issues and Other Bank Litigation and Require Banks to Report their Litigation Expense. The Comptroller's Handbook: Litigation and Other Legal Matters* (Office of the Comptroller of the Currency, 2000) is a 20 page document providing guidance to national bank examiners concerning the evaluation of a bank's litigation experience and expense. Bank managers also receive a copy. On page 1 it is noted:

> Real and threatened litigation can pose significant costs to banking organizations. Whether legal issues give rise to unenforceable contracts, lawsuits, adverse judgments, forgone business opportunities, loss of corporate focus, or diminished reputation in the community, they can disrupt the operations of a bank, possibly reducing the institution's earnings and capital. Therefore, both management and examiners must properly assess, and bank management must properly manage, the risks associated with litigation and other legal matters . . . .
>
> During bank examinations, examiners will attempt to identify any pending or threatened litigation involving the bank, assess the liabilities and any impact from those legal matters, and determine whether the bank is effectively identifying, measuring, monitoring and controlling those risks.

The examiner guidance takes particular note of lender liability lawsuits as a "significant source of potential loss for banks" (p. 3), emphasizes that behavior toward a borrower must be "rational" and "consistent with past practices and written policies and procedures" (p. 3), and calls for a "comprehensive risk management process" (p. 4). Rapid and aggressive expansion is mentioned as a cause of problems, but curiously, mergers are never mentioned in the document.

[56] Deposits are the only item on bank financial statements that is reported at the branch level. This is a decision of the regulators which could be changed. For example, small-business lending could be reported periodically at the county level.

Guidance to examiners includes the following:

> Examiners should consider whether individual suits concerning the same or similar issues evidence a pattern or practice at the bank that needs management's attention. If examiners find unanticipated risks or what appears to be a recurring pattern of litigation, they should discuss the matter with management and the board of directors. If necessary, examiners should request action plans to eliminate or mitigate the potential impact and exposure to the bank (p. 6).

Boards of directors also bear significant responsibility. For example, the examiner should "determine whether the board has established appropriate guidelines for managing the risks of litigation and other legal matters" (p. 14). Examiners should also determine whether the board discusses litigation that is pending and significant.

Requiring examiners to assess these issues is probably necessary, but as many do not have law degrees and legal experience it is at the same time problematical, especially in the case of large and complex banking organizations. An examiner in charge without a legal background may simply defer to the bank's general counsel. In many cases confidentiality requirements will mean the examiner cannot learn what he or she needs to know about the merits of a given case. Thus, it is not clear how much attention can be given to these issues in actual examinations.

The regulators alone have access to the examination reports. They are not generally made public, even in litigation. It would surely be interesting for an economist at one of the regulatory agencies to review the examination reports for some large complex banking organizations. Regulators might discover whether examiners are looking at these issues at all, and if so, how closely. For example, is the large bank that is repeatedly mentioned in this paper under any regulatory criticism for excessive lender liability?

It is not clear from the OCC document if examiners are responsible for determining whether the bank they are examining might be lead into unproductive and costly litigation by bad advice from its law firm. Nowhere in the *Handbook* is this possibility considered. Monitoring does not extend to the law firm(s) that the bank uses for defense work.

Examples of waste and abuse in connection with bank litigation abound. In *Busy Bee* it required about $1 million for the plaintiff to overcome the obstacles in putting the case before a jury. In *Taco Prima*, after weeks of pointless depositions of the plaintiffs, the case was settled in favor of these plaintiffs for $500,000. *Two partners* of the firm representing the bank delivered the check! The attorney for Taco Prima, with approximately 30 years experience as head of one of the top law firms in the area, called the expense-ridden litigation strategy of First Union "ridiculous."

In another interesting example, *Joseph v. Liberty National Bank*, a bank was sued for selling a piece of land with the representation that it was zoned commercial. It was undisputed that the land was zoned agricultural and was worth approximately

$10,000 to $15,000 less as a result. Rather than settle the case, the bank spent close to $250,000 to defend itself. The $90,000 jury verdict against the bank could almost certainly have been predicted in advance. In addition, according to counsel for Joseph, the bank used its political connections to have the jury verdict thrown out. The judge who took this action subsequently retired and could not be disciplined.

Rather than trying the case a second time, the bank settled, but then hired an out-of-area attorney at $400 per hour to contest every dollar of Joseph's counsel's legal expenses. The bank is reported to have eventually spent about $1 million on its legal defense in this case. According to the attorney for Joseph, the only reason for these actions was simple – to discourage all local attorneys from suing the bank or perhaps any bank on a contingency basis, regardless of how justified the case may be.

Liberty National's examiners are governed by the *Comptroller's Handbook*. (Bank managers are also provided with a copy as a guide to running their organization.) It should have been clear to examiners that bank management and the Board of Directors were using the resources of a federally insured financial institution to pursue their own personal agenda. It would also appear that bank examiners are not following the guidelines I have described if these types of actions do not result in severe regulatory criticism.

Regulators must ensure that their examiners are doing what the *Handbook* says they should be doing. Additional examiners with legal backgrounds (not necessarily field examiners) probably should be assigned to evaluate the performance of large and complex banking organizations, as well as others with a poor record in lender liability.

DeFerrari and Palmer (2001) discuss how regulators deal with supervision of large and complex banking organizations. One of the six major risks considered is legal risk. However, the definition of legal risk used by the regulators does not include situations in which a bank takes advantage of its superior financial position relative to the adverse party by engaging in unnecessary and protracted litigation, or engages in unethical behavior which gives rise to the litigation in the first place.

In this context it is important to point out that most banks do not even report their total litigation expense on their call reports. Litigation expense is only required to be reported if it exceeds one percent of total interest and non-interest income. Most large banks do not meet this threshold. It is difficult to see how legal risk can be evaluated effectively when regulators have surrendered their principal way of determining whether a particular bank has a pattern of litigation expense well above average for its peer group. The expense in any litigation is spread over a substantial period of time. I suggest that total litigation expense should be required to be shown on the call reports without any threshold.

6. *Consider Organizational Architecture and Develop an Organizational Architecture Database*. It should go without saying that the behavior of the loan officers described here raises serious ethical issues. Brickley, Smith, and Zimmerman (2002) suggest that a firm's "organizational architecture" includes the ethical

climate within the firm. They note that business ethics and the internal structure of the firm are "inextricably linked" because they establish the incentive structure for the individuals that comprise the firm.[57] Organizational architecture is also the subject of a textbook by the same authors (Brickley, Smith and Zimmerman (2007)).

Regulators could and should develop better information about a bank's ethical climate and "organizational architecture" before they approve mergers involving that bank. Information examiners gather about litigation history could be invaluable in this process, but the database should go well beyond that. I suggest in the previous section that regulators should require banks to provide data on their litigation expense in the call reports. That data should be incorporated into the Organizational Architecture database. Banks should also be required to report to regulators when attorneys representing the bank are sanctioned by the courts. (See the Ambrosia case above.) Anonymous interviews with former officers, securities analysts, and other professionals would be other potential inputs. Regulatory agency economists already have a wealth of information available to them within the regulatory community in examination reports to research bank ethical issues, but they should have more, and they should be encouraged to do more research on these issues.

Regulators already consider "organizational architecture," but perhaps not as closely as they could. For example, some banks are represented on Federal Reserve Boards of Directors and advisory committees, and some are not. Some mergers are approved, and others are denied. What may be more important, some bankers often speak at conferences sponsored by regulatory agencies, implicitly providing advice to other bankers on running a bank.

When the CEO of a large bank that has been the subject of repeated lender liability lawsuits speaks at a major conference sponsored by regulators, as has happened recently, what kind of message does this send? Why wouldn't we assume that the bank's lawyers and the officers who ultimately make decisions on how to deal with lender liability lawsuits are influenced by the CEO's relationship with regulators? For example, should the bank consider itself above reproach in every case and follow a contrary-to-fact, scorched-earth, zealous-advocacy defense strategy, as described in Rosenbaum (2004) and profiled in Appendix I?

Resources to develop better organizational architecture data are available from the bank's own examination reports. The current CAMELS system could be modified to include a separate rating for a bank's ethical climate. The result, a publicly available formal, organizational architecture database describing best and worst practice banking institutions, would be of significant interest to bankers, researchers, legislators and their staff, and other policymakers, and journalists, consultants and firms that sell products to the financial services industry.

7. *Adopt a Gradualist Approach to Consolidation by Denying More Mergers.* A simple method for analyzing the effect of a proposed merger on small business

[57] Brickley, Smith and Zimmerman (2002), p. 1821.

lending is proposed in Section XI. In addition, banks with a poor record in lender liability after previous mergers, particularly in cases involving disruption of small business lending, and other aspects of implementing bank mergers, such as integrating computer systems (as discussed for example in Rhoades, 1998) should not be permitted to merge until these issues are resolved. Garmaise and Moskowitz (2006) suggest that increased scrutiny of bank mergers may be warranted, and the analysis presented here supports that argument.

Over fifty years ago in the landmark *U.S. v. Philadelphia National Bank* case (1963) the United States Supreme Court established that for antitrust purposes the relevant banking market is the local area where the bank's customers do business. Its decision emphasized the local nature of small-business lending and the need to protect small-business borrowers. Bank regulators should reaffirm that, for the same reasons, the relevant market remains local and that the effect of mergers on small business lending is as important as the effect on competition. Congress should enact this point in legislation so that future generations of bank regulators always adhere to it.

8. *Prohibit Banks From Sweeping Small-Business Transaction Accounts.* Sweeping or freezing bank accounts (as occurred in the *Ambrosia Coal, Gulf and Shirey* (Appendix II) cases is the easiest way to destroy a small business.[58] Banks should be prohibited from using this practice, which occurs frequently in lender liability, without a court order. Criminal sanctions could be considered.

9. *Require Banks to Report Their Litigation Expense on Their Call Reports.* Currently, commercial banks are not required to report their litigation expense unless it exceeds one percent of total interest and non interest revenue. It appears that very few banks ever meet this threshold. There is no reason not to require total litigation expense to be reported, to allow both examiners and researchers to conduct the type of analysis suggested here. Banks have to compute the total to be sure that it is under the threshold, so there is no reason for this item to be kept secret.

10. *Consider Special Procedures.* Bank regulators should recognize that virtually every time they approve a bank merger, some small business may be hurt. They should require banks to develop special procedures to mitigate these effects, with a significant penalty if it is not done properly. Banks faced with numerous lawsuits with a fact pattern similar to the cases described in this paper should clearly be required to adopt policies to protect the small business borrowers of the banks they acquire. These banks might also be required to submit lender liability cases involving bank mergers to binding arbitration. Going further, arbitration might also be considered for all lender liability cases involving bank mergers, to reduce the expense and delay.

For larger commercial banks wanting to maintain a commitment to small business lending, the organizational structure of the former Barnett Banks has

[58] A literature search on sweeping of accounts reveals no discussion, which suggests that it is completely beyond normal and acceptable banking practices and procedures.

something worthwhile to consider.[59] Barnett Banks of Florida was a holding company with a network of semi-independent community banks, each with its own president and board of directors. These community banks could focus on relationship lending. While this structure may appear antiquated since the passage of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, allowing consolidation of independent banks within a holding company, it would facilitate the customized, labor intensive, small-business lending done by small banks (as described, for example, in DeYoung, Hunter and Udell (2004)) within a larger banking organization. Regulators might consider encouraging aspects of such a structure at some institutions.

XIII. SUMMARY AND CONCLUSIONS

Banks have tangible and intangible assets and tangible and intangible liabilities. The value of the bank is the difference between the two items. One of the intangible assets is the value of repeat business. As a merger approaches, the value of repeat business for the disappearing bank drops sharply; officers of the disappearing bank often have no interest in some of their former customers and they have little or no incentive to treat them well. As Carow, Kane and Narayanan (2006) suggest, the drop in credit availability to small business found in previous studies may be a result of this process.

Since the potential exists that a large number of borrowers are mistreated in some mergers, bankers involved in mergers often engage in aggressive, scorched-earth defense tactics to prevent the case from coming to trial and to raise the cost of litigation for the plaintiff. If they did not, other borrowers would be encouraged to pursue their claims as well, and the reputation of the bank would suffer. This theory predicts that lender liability will result from bank mergers and bank management will use aggressive tactics to prevent these cases from being litigated. If they were litigated successfully, other potential litigants would emerge and the reputation and value of the bank would deteriorate.

The events of the six cases are consistent with the theory. In one case a bank withheld documents for six years and knowingly exposed itself to sanctions rather than reveal its motives in terminating the loan. In another egregious case a bank forced a plaintiff to spend one million dollars to bring the case to trial. Similar aggressive defense tactics have been used in other cases (Table 1). This suggests that these cases are not just random events but may represent only the tip of the iceberg.

Bank mergers have been shown to reduce credit availability in a number of studies. Since small firms depend on credit for their very existence, owners and managers of small firms do have a reason to fear a merger of their bank with a larger institution. Looking at this issue using survey data of firms obtained after a merger, a procedure used in a number of prominent studies, raises certain problems if mergers reduce credit availability. The only firms considered are the ones that

[59] Mayer (1997, pp. 239–245) describes this structure in some detail. Also see footnote 11.

survived the merger. Suggesting that the effect will cure itself in the long run, an argument advanced in other studies, misses the point since for many small businesses deprived of credit, in the long run we are all dead.

While bank regulatory agencies instruct their examiners to evaluate an institution's litigation experience, it is doubtful that many examiners have the background to do this. Bank regulators need to improve these procedures and develop a database to measure a bank's organizational architecture – its ethical climate in its dealing with stakeholders. Bankers which are repeatedly involved in lender liability lawsuits, such as the one large bank involved in five of these six cases, should be denied the privilege of engaging in future mergers until there is a change in organizational architecture.

In summary, I suggest that regulators seriously consider the recent suggestion of Carow, Kane and Narayanan (2006) that they take significant action to ensure that participants in bank mergers preserve target bank relationships. My study and theirs see that as fundamental in avoiding the obvious negative impact on small business lending and economic growth that will otherwise continue to occur as bank consolidation proceeds.

XIV. APPENDICES

APPENDIX I: A SCORCHED-EARTH, ZEALOUS-ADVOCACY DEFENSE ATTORNEY CONVINCES AN APPEALS COURT THAT SMALL FIRMS DO NOT DEPEND ON CREDIT

Barnett Bank v. Shirey (Counterclaim) involves a used car dealer who lost his source of financing in a breach of contract case. The Appeals Court decision is a sad commentary on the role of the judiciary in lender liability. The floor plan loan contract clearly called for the bank to finance each automobile at its value in the "black book," an accepted guide used by auto dealers. The loan officer, a former consumer lender, ignored the contract and would finance only at a consumer loan standard, NADA book value, which was substantially lower. Shirey initially won a jury verdict in Ocala, Florida, in 1993 for $812,000 in economic damages, with total damages including punitive damages[60] totaling $1,377,000.

At trial and on appeal, defense attorneys attempted to deny that a retail firm needs credit to survive. (As noted earlier, the U.S. Supreme Court in *U.S. v. Philadelphia National Bank* issued a strongly worded opinion to the contrary.) The Florida District Court of Appeals actually accepted the defense reasoning, set aside the jury verdict, and ordered a new trial. The Court relied heavily on a brief exchange at trial as follows, which the attorney for Shirey claims was misstated and taken out of context:

[60] The punitive damages were associated with a bank officer's disclosure of confidential information about Shirey's difficult financial situation to assist a prospective buyer of the distressed dealership in purchasing the property at an attractive price. The bank officer did this so the Bank could obtain the buyer's trust business. The Appeals Court also rejected the notion that the bank was responsible for this action.

Q: Are you going to answer my question whether you had the money in the business to pay the difference between black book and NADA loan?

A: Yes, sir. I had the money to do that.

It is, of course, theoretically possible to finance inventory and other working capital with equity, but as financial management textbooks stress, this is inefficient because of the high cost of equity relative to debt and the lack of flexibility (see, e.g., Brigham (1995)) The amount involved was, according to the defense, only \$22,000.[61] (The plaintiff's higher and more accurate estimate of the financing gap was never considered by the Appeals Court.)

Assume for the sake of argument that the average difference between the two loan standards is \$1,000 per car. Following this defense reasoning, using owner's equity would have allowed Shirey to finance only 22 cars. His inventory before the breach of the lending agreement was generally at least three times that amount. Clearly, an automobile dealer's financial success depends on the number of automobiles he has in inventory. The Court never acknowledged that crucial point.

The Court also attempted to perform the function of an economist expert witness itself, although not very well. The majority concluded that the bank might have been responsible for the loss of part of Shirey's business, but the "evidence did not establish that borrowers' dealership was *entirely* destroyed *solely* because Bank failed to lend . . . " (p. 2, emphasis added). This line of reasoning requires that a business be completely free of any and all other problems to establish that the bank was "solely" and "entirely" responsible. What small business does not have some other problems beyond financing?

Moreover, assuming that a business can be arbitrarily divided into healthy and damaged portions ignores the role of fixed cost and fails to recognize that the relevant revenue, cost, and profit concepts are marginal numbers, not total or average. The Court thus accepted the defense's argument, with minor modifications: Essentially, small firms do not need financing. In addition, as Justice Thompson noted in his dissent, the majority ignored the fact that the Bank froze Shirey's bank accounts so that his business could not function!

Rosenbaum (2004) discusses the zealous advocacy defense tactics that occasionally win verdicts such as this one, and the attorneys who develop the contrary-to-fact theories of the case behind such tactics. He comments:

> The fact is, nobody likes people like these. You don't invite them to your house. You don't want them near your children. You don't want them breathing too close next to you. So why does the legal system hold open casting calls for, and reward so handsomely, the zealots among us? They are given the privileged position as the guardians of our most

[61] "Each time bank breached its agreement by loaning under lesser formula, dealership had money to fund difference until it could have succeeded in enforcing its rights under loan agreement" (p. 2). The Court completely failed to recognize that the amount of equity available to a small firm is quite limited, and the opportunity cost is quite high.

> intimate secrets and purveyors of our necessary truths. But they have never received our trust, nor do they deserve it.
>
> There is such a thing as advocacy without zealotry – principled advocacy, honorable advocacy, moral advocacy, but without the rage and gamesmanship that is being played out presumably on our behalf, but mostly to our detriment.[62]

Another tactic used in Gulf is delay. Bank counsel moved for summary judgment (i.e., to dismiss the lender liability claim against the bank and enforce the one, remaining outstanding loan). Summary judgment can only be granted if there are no genuine issues of material fact, which was clearly not the situation. Nonetheless, a hearing was set for the judge to hear the motion, but bank counsel repeatedly moved to postpone the hearing at the last minute. This forced Gulf's counsel to prepare and re-prepare for several hearing. This increased the cost to the company substantially. The bank continued this procedure for several years.

Numerous frivolous motions are no doubt part of any scorched-earth zealous advocacy defense strategy in a lender liability case. Bankers know that juries will not treat them well if the evidence shows that their actions have destroyed a small business, and they often do whatever they can to prevent these cases from coming to trial.

APPENDIX II: APPROPRIATE LOAN WORKOUT PROCEDURES

Banks involved in a merger may be particularly likely to deviate from normal procedures when it comes to loan workouts. Loans in workout present the most uncertain cash flows of any loans in a bank's portfolio, and are thus the most difficult to value. Thus, it is likely that during a merger, with pressure to show a clean, or at least understandable, balance sheet to the merger partner, it is in loan workouts that merging banks often create lender liability problems for themselves. Some loans at merging banks bypass the workout process altogether and proceed to collection (i.e., the "Special Assets" department).

The loan workout procedures described in West Florida, Busy Bee, Onyx, Gulf, and some of the other cases are similar to those which Budnitz (2006) describes as pre-lender liability, pre 1980 procedures:

> In the old days, before lender liability became a major concern (i.e, before 1980) many workout officers were like marine captains – stern, uncompromising, terrifying. They were trained to be bullies who enforced the strict letter of their loan agreements no matter how devastating the consequences for the borrower, and they got away with it because they never had to explain their actions to a jury.
>
> Now, the rules have changed, and lenders are expected to deal fairly with borrowers. Some institutions have always employed workout professionals who understood the importance of compromise; others have had to learn new rules. In any event, lenders have

[62] Rosenbaum (2004, p. 132). This book was reviewed favorably in *The New York Times* (Liptik (2004)).

> learned that they can handle workouts effectively without being confrontational and that they can relax the strict covenants of their loan documents in order to accommodate the needs of their borrowers, with results that inure to the benefit of their own institutions and their borrowers. The key is a cool, rational analysis of the lender's position and a fair and deliberate program to implement the lender's workout strategy.

In a loan workout, responsibility for the loan relationship is transferred to a skilled professional, and the bank instructs the borrower to make all contacts with the bank through the workout officer. Workouts require a specialized set of experience and skills, and the original loan officer has probably too much invested emotionally in the personal relationship to handle the situation effectively.

The workout officer determines the reasons for the default and analyzes the course of conduct during the loan relationship. Any history of accepting late payments, honoring overdrafts, or other types of forbearance must be documented for consideration. Loan workout personnel should examine the entire credit file and related documents and the lender's collateral position. A workout agreement is drafted, and the business firm is given a period of time to restructure its operations, if necessary; loan rates and terms are often modified to give the borrower some room to restructure.

The need for a good loan workout agreement, and its purpose, are clear: "There is no loan relationship that terminates without the opportunity for at least one workout agreement . . . . The workout strategy must give the borrower the right to survive if it can while giving the lender the protection it needs" (Budnitz (2006)).

Even in a competitive marketplace, it can take significant time for a business borrower to find a new lender. If this is the bank's goal, and often it is in a loan workout, the workout agreement must recognize this point. Financial projections, preferably preferred by the borrower in connection with a business plan, are an integral part of the agreement. The bank needs to avoid any actions, or even suggestions, that involve it in the day-to day operation of the business, including decisions such as pricing, product lines, and personnel. Attendance at board meetings and any sudden change in the way the bank deals with the borrower should be avoided.

If a workout fails, the lender needs to carefully consider the situation before suing on a deficiency. Lender liability lawsuits often occur as a counterclaim against the bank's original claim for payment in full. Budnitz cites several cases of a bank losing much more in the lender liability lawsuit than it could have ever hoped to gain in litigation. Interestingly, in *Onyx* and *Gul,f* the lender ignored this point, not to mention other basic loan workout concepts.

These suggested procedures, while based on a set of lender liability studies (Budnitz (2001), Capello and Kopmoreske (1993), Maly (1985)), are completely consistent with what finance professionals would advocate. Herring (1989) suggests that loan workouts may be mutually beneficial. Finance theorists would emphasize preserving, maintaining, and maximizing a firm's cash flow to all stakeholders during periods of financial difficulty. In fact, classic studies by Petersen and Rajan (1994, 1995) suggest that one reason bank relationships have more value than other forms of debt arrangements is that lenders can be flexible during periods of financial distress. This notion of a renegotiation option in a bank loan is also reflected in theoretical studies by Gorton and Kahn (2000) and Bester (1994).

These notions even find their way into the basic course in finance. In an earlier edition, Brigham's (1995) classic introductory text describes how Bank of America successfully worked with Memorex's management to lend the firm additional funds during a period of severe financial difficulty. Memorex's stock price went from $1.50 to about $68 after the successful loan workout. A recent article in *The Wall Street Journal* (Wysocki (2007)) describes other recent examples.

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