

Finance Theory, Lender Liability, and the Value of Banking Relationships: A Survey and Interpretation

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This paper summarizes financial theory and empirical studies related to the case law on lender liability, focusing particularly on breach of contract. Lender liability reflects asymmetric information, market imperfections, and transactions costs. It appears to arise in part from agency problems between the bank and the loan officer. Damage awards from lender liability cases illustrate that the value of a bank loan relationship is substantial.

Introduction

Banking relationships are immensely valuable to borrowers and to banks. Bernanke (1983) attributes part of the Great Depression of the 1930s to the destruction of bank-borrower relationships and the subsequent increased real cost of financial intermediation for small firms, farmers, and consumers. Retail grocery businesses and real estate firms typically cannot survive without credit. Automobile dealers depend on floorplan financing, a revolving line of credit to finance their inventories. Finance theory deals with this issue of value and there is considerable literature applying this theory to estimating the value of loan relationships. There is also a growing body of legal precedent with regard to lender liability. My focus in this survey article is the value of the intermediation services that banks provide, interpreted from the perspective of breach of contract. In other words, what happens when valuable loan relationships are destroyed through a bank's actions? Breach of contract is the most basic area of lender liability and the one with the most potential to provide information on the value of banking relationships.

Lender liability deals with the obligations lenders have to borrowers and the consequences when lending relationships are disrupted. Judgments in lender liability cases indicate substantial damages to a business when a bank credit line is withdrawn. When Irving Trust broke a commitment to lend \$3.5 million to a firm in

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the retail grocery business and heavily dependent on credit, the court awarded \$7.5 million in damages [*K.M.C., Inc. vs. Irving Trust*, 757 F.2d 752 (6th Cir. 1985)] In *Ricci vs. Key Bankshares of Maine* [662 F. Supp 1132 (1987)] the economic damages from the termination of a \$1 million loan to a real estate firm were \$5 million. Damage awards from lender liability cases illustrate that the value of a bank loan relationship is substantial. Both finance theory (and related empirical research) and lender liability deal with a similar issue, namely the value of a banking relationship. I conclude that lender liability reflects asymmetric information, market imperfections, and transactions costs and appears to arise in part because of agency problems between the bank and the loan officer.

Banks have been sued for breach of contract, fraud, breach of fiduciary duty, duress, tortious interference in business affairs and corporate governance, and bad faith. (See Cantor, Kerr and Rice (1987) concerning legal theories of lender liability.) This paper focuses on the area of lender liability case law that deals with breach of contract; as noted, that is the most basic area of lender liability and the one that has the greatest potential to illuminate the value of banking relationships. While a large literature on the value of loan relationships exists and there are extensive legal treatises on lender liability, the relationships between the two subjects have rarely, if ever, been explored.

Finance Theory and Empirical Studies

Theoretical Research. What aspects of finance theory are most relevant to lender liability? They basically relate to information and contracting costs in an imperfect market. Researchers have examined the value of a lending relationship to both bank and borrower. Diamond's (1984) delegated monitoring hypothesis shows how banks reduce asymmetric information problems by developing close working relationships with loan customers, by applying specialized expertise and information processing techniques to monitor borrower financial condition, and by diversifying risk through contracting with a large number of borrowers. Ramakrishnan and Thakor (1984), Boyd and Prescott (1986), Rajan (1992), Boyd and Runkle (1993), Boot and Thakor (1994, 2000), Petersen and Rajan (1994, 1995), Von Thadden (1995), and Detragiache, Garella, and Guiso (2000) extend Diamond's theoretical work.

In essence this literature views the bank as providing certification value for the firm—by making or renewing a loan, the bank signals to investors that it has confidence in the firm and its managers. Boot (2000) provides a comprehensive summary of much of this literature, but does not deal specifically with lender liability issues. Boot's survey concludes that reduction in information asymmetries is the *raison d'être* for financial intermediaries.

Greenspan (1993) offers a bank regulator's view that "the credit insight of the banker" and the ability to evaluate risk is the primary source of economic value

added by banks. This suggests that the loan officer (typically the key figure in a lender liability case) can create or destroy value depending on how the relationship is managed. O'Hara's (1983) dynamic theory of the banking firm similarly shows that the value of a bank arises from information available to it about the borrower.

Market imperfections may diminish the value of a banking relationship to a borrower. Sharpe (1990), Rajan (1992), and Houston and James (1996) suggest that dealing with one bank creates an information monopoly because it is costly to switch lenders. The bank may attempt to exploit its monopoly position and appropriate some of the gains from the firm's investment projects, which would distort the firm's ability to make optimal investment decisions. Houston and James suggest that dealing with multiple bank lenders may be an effective way to limit these potential "hold-up" costs. The analysis in these papers implies that lender liability cases may be more likely to arise in small markets with few alternative lenders. [See Capello and Komoreske (1993) and some of the cases cited there.]¹

Greenbaum, Kanatas, and Venezia (1989) find that the value to a bank of a relationship with a borrower arises from the bank's information advantage and the prospect of future business. They also conclude, in contrast to Lummer and McConnell (1989), that because the second item declines in value over time, the value of the relationship to the bank is diminished the longer the relationship.

Contracting costs provide another source of value in bank loans. Fama (1985) notes that contracting costs are lower for bank debt than for outside debt, especially for small companies. As a result, small businesses will be willing to pay higher interest rates than large companies on business loans. This makes bank loans special, even in a competitive marketplace. Moreover, in Fama's analysis, loans provide valuable signaling effects. Therefore, banks have a comparative advantage in making loans over other intermediaries.²

Nakamura (1989), Berlin and Mester (1990), Gorton and Kahn (1993), and Bester (1994) examine the value of relationships in the case of loan defaults. In the event of default there is an implicit renegotiation option in a loan contract that is generally not available in the case of public debt. A bank can be more flexible when circumstances change than can a diverse group of bondholders. Thus, bank renegotiation may produce the more favorable outcome.

Empirical Research. Bernanke's (1983) examination of the Great Depression is closely related to my theme in this paper. He notes that the destruction of bank-

¹ *Shirey vs. Barnett Bank of Marion County* (Marion County, Florida, 1992) is a breach of contract case involving floorplan lending, a revolving line of credit to finance a dealer's automobile inventory. Barnett was the only floorplan lender in the county, and Barnett Bank of Alachua County (the adjacent county) was prohibited from soliciting floorplan loans in Marion County. Shirey claimed he had no alternative lender when the bank failed to honor the original floorplan agreement, and that the lack of credit caused his auto dealership to fail.

² The sources of this comparative advantage are discussed in detail in Fama (1985, pp. 35-38).

borrower relationships in the United States during the 1930s led to increased real costs of financial intermediation for small firms, farmers, and consumers. Value destruction on this scale illustrates what can happen on a microeconomic level when a bank credit line is withdrawn.³

The theoretical literature on bank monitoring discussed above (Diamond, 1984; Ramakrishnan and Thakor, 1984; and Boyd and Prescott, 1986) indicates that evidence of a continuing relationship between a bank and a borrowing firm sends positive signals to investors and would tend to raise the value of the firm's equity. The bank relationship has certification value, signaling that the bank has confidence in the firm and its managers.

James (1987), Lummer and McConnell (1989), Slovin, Johnson, and Glascock (1992), Boyd and Runkle (1993), and Peterson and Rajan (1994) provide empirical tests that generally support this notion that monitoring creates value. The typical evidence is that announcement of a new loan commitment has a positive effect on the stock price of the firm. A more recent literature looks at data from bank loan files or surveys to directly estimate the value of relationships. Examples including both U.S. and foreign data include Cole (1998), Elsas and Krahnen (1998), Harhoff and Korting (1998), Degryse and Van Cayseele (2000), and Ongena and Smith (2000, 2001).

James (1987) states that an implication of Diamond's (1984) delegated monitoring analysis is that bank loans are different from bonds because "banks know more about a company's prospects than other investors do" (p. 217). They thus provide something of value that is not available from other lenders, such as insurance companies. He finds positive abnormal returns of 1.93 percent to stockholders of firms announcing new bank loan agreements, but negative abnormal returns for those announcing public and private placements, which is consistent with the hypothesis. The positive abnormal returns cannot be attributed solely to the information asymmetries associated with new investments, which would confirm the importance of ongoing monitoring in the value creation process.

Lummer and McConnell (1989) find excess returns only for revisions to existing loans, which they interpret to mean that bank loans per se do not convey information. Again, a bank's information advantage comes only through a continuing relationship with the firm. This analysis suggests that the value of intermediation services to both the bank and borrower increases as the relationship matures.

Slovin, Johnson, and Glascock (1992) find a positive share price reaction to a loan announcement for smaller firms only. They consider this finding to be consistent with Diamond (1984) and Fama (1985) because small firms are the ones

³Recently, Bae, Kang and Lim (2002) revisit this notion in the context of the 1997-98 Korean banking crisis. They find less value destruction during the crisis for firms with more durable banking relationships. Durability is measured by the financial health of both the bank and the client firm.

for which asymmetric information problems would be greatest. Slovin, Sushka, and Polonchek (1993) find a nine percent decline in the stock price of a portfolio of firms when a bank relationship is terminated and investors became aware that effective monitoring of these firms by Continental Illinois Bank had apparently not occurred. Churchill and Lewis (1985) (1986) confirm that lending relationships are valuable to banks, and again that relationships with smaller firms are more valuable (in proportion to loan size) than with larger ones.

Peterson and Rajan (1994, 1995) consider the bank's information advantage to be a source of monopoly power that enables the bank to obtain some of the gain from a customer's positive net present value project. A monopoly bank can subsidize a firm in its early years and in conditions of distress. A bank in a competitive market is less likely to do this because the bank cannot expect to charge higher interest rates later or in return for lower rates today. Thus, lending relationships are less valuable to a borrowing firm under competitive conditions (and more valuable when there are imperfections in the loan market) because market conditions limit the extent to which the lender can share in the net present value of the project; this limits the value of the subsidy.

Houston and James (1996) find empirical support for Rajan's (1992) abovementioned information monopoly argument. The "hold-up" costs associated with borrowing from a single lender limit the use of bank debt and these costs appear to be particularly severe for firms with substantial growth opportunities. Nonetheless, it may still be optimal for small firms to borrow from one lender if the benefits from bank monitoring outweigh the hold-up costs. Peterson and Rajan (1994) find that, for small firms, borrowing from a single lender increases the availability of credit.

Researchers also have determined that it matters who makes the loan. Billett, Flannery, and Garfinkel (1995) find higher abnormal returns on the borrowing firm's equity when its lender's credit quality is higher. They suggest three reasons why the credit rating of the lender might matter. First, there may be shared benefits from a longstanding relationship; such a relationship is more likely to occur if the lender is expected to survive longer. Second, a bank with higher credit quality is likely to have a superior monitoring technology and be able to devote more resources to monitoring. Third, a high credit quality bank may earn reputational rents and limit its risks by specializing in loans to high-quality firms. Thus, loan announcements by high-quality lenders may provide more accurate information to investors. Billett, Flannery, and Garfinkel report: "an announced loan from a 'good' banking firm conveys more information about borrower prospects than would a loan from a mediocre bank" (1995, p. 717).

Lender Liability and Finance Theory

Lender liability deals with obligations lenders have to a borrower and the consequences for both parties when lending relationships are disrupted. This case law dates at least to the 1930s, but, as Bloom (1989) indicates, it increased in scope in the 1980s because of a broadened application of traditional common law theories to bank activities. Lender liability is a broad concept that includes fraud, break of fiduciary duty, lack of good faith, intentional or negligent misrepresentation, misuse of confidential information, improper declaration or wrongful acceleration of default, addition of loan conditions after acceptance, unwarranted interference with and/or control of the operation of a business, and forbearance.⁴

I focus on breach of contract. In the typical case, a bank agrees to provide funds to a business. The borrower relies on that promise, but the bank later refuses to fund part or all of the loan or accelerates the repayment clause. The business allegedly suffers damages as a result of the lack of funds, and a lawsuit for breach of contract ensues. [Berlin and Mester (2001) also deal with lender liability, but their analysis is in the context of equitable subordination, as different area of the case law.]

Finance theory is relevant to lender liability in three particular respects: (a) asymmetric information, (b) transactions costs, and (c) competition. Asymmetric information is virtually always a factor in lender liability. A bank has much more knowledge of its borrower than other lenders would, generally through an ongoing business relationship or, in the case of a new loan, a recent credit evaluation. If the borrower should renege on a loan commitment, it is often difficult for the borrower to replace the loan with a new one. Even if this can be done, it may require substantial time, when the business could suffer damages, including the loss of the business itself. In *K.M.C. vs. Irving Trust*, the Court concluded that a firm in the competitive retail grocery business is heavily dependent on credit for its day-to-day operations, and that its failure was the result of withdrawal of a line of credit.

Transactions costs include commitment fees and the cost of preparing loan documents. A business that has paid these costs may find it particularly hard to secure a new loan in time to avoid damage to its business. Competition is relevant because it affects the ability of the borrower to secure another loan. If there were not asymmetric information, if transactions costs were negligible, and if loan markets were perfectly competitive, a borrower losing bank financing could immediately arrange a new credit line with another lender, and damages would be insignificant or nonexistent. Thus, most lender liability cases contain one or more of these elements. The decline in firm value created through the interaction of these three forces gives rise to the damages.

⁴Detailed discussions include Bloom (1989), Cantor, Kerr and Rice (1987), Cappello and Komoroske (1993), Chaitman (1985, 1987), Mannino (1997) and Tufaro (1987).

Lender liability cases often arise in problem loan situations. The costs of problem loans to a bank are discussed in a Robert Morris and Associates publication, *Problem Loans and Loan Strategies* (1985, 1997). Maly (1987) also discusses strategies for working with a borrower in periods of adversity to mitigate the value destruction and lender liability that could occur if the bank declares a loan in default.⁵ Even elementary finance textbooks (e.g., Brigham, 1995, p. 673) suggest that loan workouts are often preferable to forcing a business with financial problems to liquidate its loans. Brigham also presents a specific example of value creation resulting from such a strategy.

Carey, Post, and Sharpe (1998) suggest one explanation for their empirical finding that banks (relative to finance companies) specialize in loans to less risky borrowers: Banks value their reputation for reasonableness in debt renegotiations. Borrowers, of course, see some bank renegotiation behavior as unreasonable, which often results in lender liability.

A final important question remains—why would a rational financial institution destroy value in a firm that owes it money? Several of these cases contain incidents of personal conflict between a loan officer and the owner of the firm and/or a loan officer's failure to investigate key facts about the company before modifying or terminating a loan agreement.⁶ In some cases, a loan officer allegedly ignored or failed to consider the firm's dependence on bank credit before withdrawing the loan.⁷ This suggests that lender liability is an example of the agency problem between the bank and the individual loan officer, as reflected in Udell (1989). He observes that a bank has an incentive to monitor the actions of individual loan officers because they may use their positions for personal gain to the detriment of the bank. In the extreme case, evaluations of many failed banks reveal kickbacks to loan officers. A bank loan review function is an effort to mitigate this agency problem by monitoring loan officer performance. (This agency issue differs from the well-known

⁵Chapters 1 and 8 of Robert Morris and Associates (1985, 1997) are closely related to the lender liability issues discussed here.

⁶Chaitman [1987] lists "Ten Commandments for Avoiding Lender Liability"; the first is 'Don't Act Impulsively.' See also Chaitman (1985, pp. 67 and 376). The decision in Ricci vs. Key Bankshares of Maine, 662 F. Supp 1132 (1987) contains another example. This lender liability case allegedly arose in part from the loan officer's personal bias against the borrower because of his Italian-American background. In the Shirey case (footnote 1), the loan officer allegedly failed to consider the effect on the borrowing firm when he modified the formula for calculating the amount of credit provided.

⁷The abovementioned decision in *KMC vs. Irving Trust* that a firm in the competitive retail grocery business cannot survive without bank credit parallels the literature and teaching in finance on the optimal capital structure, maturity matching and the inefficiencies involved in using equity to finance temporary working capital. Hence, finance texts suggest that firms finance inventories and accounts receivable primarily with bank loans. See, for example, Brigham (1995), pp. 434 and 655.

moral hazard problem between the deposit insurance fund and the bank (Udell, 1989, p. 381).

Nakamura (1993) also considers monitoring of loan officers to reduce agency costs to be an important factor affecting bank financial performance. He argues that small banks are better at this agency cost reduction than large banks because senior management is closer to both loan officer and borrower.

Illustrative Damage Awards as Indicators of Value

Lender liability damage awards convey information about the value of a bank credit line to a borrower because they reflect economic damages. Expert witnesses generally estimate the value of the firm, both before and after the breach, using generally accepted techniques. The fact that damages were awarded indicates that there was evidence, which the court accepted, that a firm's damages were a direct result of the withdrawal of the line of credit. Courts generally require that expert witnesses present and defend the growth rates, discount rates, and other assumptions behind their estimates. Further information about the market value of the firm is provided by evidence of third party offers to purchase the company (*K.M.C. vs. Irving Trust*, 1985; Chaitman, 1985). Estimates based on multiple approaches are sometimes presented.⁸

Data. I use the lender liability cases in Cappello and Komoroske (1993) to review the opinions in over 60 appeals court or state supreme court decisions. Of these, only 30 specify the amount of the damages initially awarded by the trial court. I further eliminate consumer lending cases, residential mortgage loan cases, and business loan cases not involving breach of contract. The remaining 20 cases are all breach of contract cases where the court found that withdrawal of a commercial loan or failure to fund a promised line of credit created economic damages for the business borrower. For consistency, I use the damages in the original jury verdict. Some of the awards include additional amounts, e.g., for punitive damages, intentional infliction of emotional distress, and pre- and post-judgment interest. These are specifically excluded here when the information is available. I focus on compensatory damages—generally, the value of the firm's economic loss. Damage awards may include other factors in addition to the value of the relationship that cannot be separated, such as the opportunity cost of the capital and managerial effort employed in the business. Thus, the data are illustrative only.

The table summarizes the data on loan amounts and damages. The data indicate that the value of a loan relationship appears to be substantial; in the large business loan cases the median is \$4.25 million. For both large and small loans the median

⁸Chaitman presents a case in which estimates based on four approaches were presented to the jury—a "liquidation loss" approach, a "stockholders' equity" approach, a "fair market value" approach and an "asset, goodwill, and profit" approach (1985, p. 1323).

ratio of the damages to the loan amount is greater than one, and higher than one in 16 of 20 cases. For both large and small loans, the median ratio of damages to the loan amount is greater than one.

Table 1—Summary of Loan Amounts and Damage Awards

Loans of \$1,000,000 or More		Loans Less Than \$1,000,000	
Number of Cases	8	Number of Cases	12
Damages:		Damages:	
Mean	\$18,710,000	Mean	\$706,789
Median	\$4,250,000	Median	\$374,500
Loan Amount:		Loan Amount:	
Mean	\$16,040,000	Mean	\$251,920
Median	\$4,250,000	Median	\$150,000
Ratio of Damages to Loan Amount:		Ratio of Damages to Loan Amount:	
Mean	1.086	Mean	2.365
Median	1.080	Median	1.230

Means and medians are based on the individual ratios from each case; they are not ratios of mean and median amounts

Summary and Conclusions

The literature on the value of loan relationships casts light on the issues that we see in the case law on lender liability. Likewise, lender liability data illustrate the value of loan relationships.

Finance theory implies that a loan relationship with a bank is more valuable to a business firm in the presence of market imperfections and when the loan relationship has prevailed long enough to resolve asymmetric information problems. Extending this line of thought, there would generally not be lender liability in the absence of asymmetric information, transactions costs, and market imperfections. Lender liability reflects the agency problem between bank and loan officer. Lender liability damage awards illustrate the substantial value of bank loan relationships.

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