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Lender Liability: A Survey of Common-Law Theories

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Lender Liability: A Survey of Common-Law Theories*

I. INTRODUCTION 855
II. TRADITIONAL THEORIES OF LENDER LIABILITY 857
III. EMERGING THEORIES OF LENDER LIABILITY 861
A. *Breach of Fiduciary Duty* 862
1. Control 862
2. Special Relationships 867
B. *Tortious Lender Liability* 872
1. Fraud 873
2. Duress 875
3. Interference with Advantageous Relations 876
4. Negligence 878
5. Prima Facie Tort 878
C. *Duty of Good Faith—Tort or Contract?* 879
1. Line of Credit Cases 880
2. Demand Note Cases 882
3. Tortious Breach of Good Faith 883
IV. EFFECTS OF LENDER LIABILITY 885
V. JUDICIARY'S RESPONSE 887
VI. CONCLUSION 889

I. INTRODUCTION

Lender liability litigation has increased dramatically over the past several years. The increase in claims is hardly surprising when one considers recent multimillion dollar recoveries.[1] Such well-publicized verdicts against lenders serve to encourage borrowers to defend even routine collection claims by striking out at the lender.

Most often borrowers bring lender liability suits following commercial loan defaults. These suits are based on a number of common-law theories for liability including: breach of contract,[2] breach of fiduciary duty,[3] and breach of good faith,[4] as well as fraud,[5] duress,[6] interfer-

* Through the Special Project, this piece is cited as Special Project Note, *Lender Liability.*

1. *See, e.g.,* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1984) ($3.6 million award against lender); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984) ($18.6 million award against lender).

2. *See infra* notes 18-57 and accompanying text.

3. *See infra* notes 64-134 and accompanying text.

ence,[7] and negligence.[8] Some suits also raise statutory claims under the bankruptcy laws,[9] the federal securities laws,[10] the tax laws,[11] the environmental laws,[12] and the Racketeer Influenced and Corrupt Organizations Act (RICO).[13]

The success of many of these theories of liability has broadened the scope of lender liability and has helped borrowers fight back against overreaching lenders. Because many of the theories are relatively new to the banking area, however, courts have yet to define the theories' parameters. This lack of judicial guidance leaves lenders in a difficult position. They face harsh economic consequences for failure to aid a troubled debtor, and potential liability if they do become involved.[14] The uncertainty of the law makes it difficult for lenders to evaluate their risks. Consequently, evaluation has become more expensive. This evaluation expense and other increased costs eventually are passed on to borrowers and other bank customers. Furthermore, lenders often react by narrowing or curtailing important lending functions.

Parts II and III of this Note describe the most prevalent theories of lender liability, focusing on common-law theories and highlighting prominent cases under each theory. Conflicts among jurisdictions are emphasized to show the need for guidelines and standardization. Part IV analyzes the impact of increased liability on lenders, and Part V examines the judiciary's response depicted by several recent cases. Finally, Part VI concludes that until a body of law evolves in the area of lender liability, both lenders and borrowers will bear the costs of expanded and uncertain claims against lenders.

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4. *See infra* notes 199-257 and accompanying text.

5. *See infra* notes 152-60 and accompanying text.

6. *See infra* notes 161-71 and accompanying text.

7. *See infra* notes 172-81 and accompanying text.

8. *See infra* notes 182-86 and accompanying text.

9. *See* 11 U.S.C. § 510(c)(1982). Section 510(c) of the Bankruptcy Code provides for the equitable subordination of claims. *Id.*

10. *See* 15 U.S.C. §§ 77(o), 78t(a) (1982). If a lender is found to be a controlling person, the lender may be liable under the Securities Act of 1933, *id.* § 77(o), and the Securities Exchange Act of 1934, *id.* § 78t(a).

11. *See* I.R.C. § 3505(a) (1982). A lender that provides a borrower with funds to be used for payroll may be liable for failing to collect and remit withholding taxes. *Id.*

12. *See* 42 U.S.C. §§ 9601-9657 (Supp. IV 1986). A lender may be liable if hazardous or toxic materials are found on premises mortgaged by the lender. *Id.*

13. *See* 18 U.S.C. §§ 1961-1968 (1982). A lender may be liable for engaging in activities prohibited by the Racketeer Influenced and Corrupt Organizations Act. *Id.*

14. Swartz, *Lender Liability*, U.S. BANKER, May 1986, at 10.

II. Traditional Theories of Lender Liability

Lender liability is not a recent phenomenon.[15] Borrowers have been suing banks for many years, though perhaps not as frequently or successfully as in recent years.[16] Traditionally, a borrower's claim against a lender fell almost exclusively under the contractual rubric. Some of the theories that plaintiffs and courts now apply to lending situations, however, are new.[17]

Contractual lender liability is not as popular among plaintiffs today[18] as tort liability is because of the comparatively smaller, more limited damages available under a contract theory. Compensatory damages do not attract as much fanfare as the multimillion dollar punitive damages available under a tort theory.[19] Contractual damages are designed to award a party the "benefit of the bargain";[20] however, they specifically are not designed to punish the breaching party, nor to award speculative or unforeseeable damages.[21] Consequently, plaintiffs today, in

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15. *See, e.g.*, Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 64 P.2d 101 (1937); Earl Park State Bank v. Lowmon, 92 Ind. App. 25, 161 N.E. 675 (1928).

16. The following cases were listed in the August 1988 *Lender Liability Law Report* as among the top ten highest lender liability judgments in 1987: FDIC v. W.R. Grace Co., 691 F. Supp. 87 (N.D. Ill. 1988) ($100 million damages); Scharenberg v. Continental Ill. Nat'l Bank & Trust Co., No. 87-0238-CIV-DAVIS (S.D. Fla. 1987) ($105 million compensatory damages); Penthouse Int'l, Ltd. v. Dominion Fed. Sav. & Loan Ass'n, 665 F. Supp. 301 (S.D.N.Y. 1987) ($129 million compensatory damages). 2 Lender Liability Law Report, Aug. 1988, at 2-3 [hereinafter Lender Liability Report].

17. For example, tortious breach of the implied covenant of good faith, discussed *infra* notes 238-56 and accompanying text, only recently has been acknowledged as a valid cause of action in a commercial setting. Additionally, the torts of interference, discussed *infra* notes 172-81 and accompanying text, and negligent misrepresentation, discussed *infra* notes 156-60 and accompanying text, only recently have been applied to lenders. Breach of fiduciary duty, discussed *infra* notes 64-134 and accompanying text, also is new to the lending context.

18. Some plaintiffs, however, contrive to base their claims against lenders solely on contractual theories. *See, e.g.*, Verbaere v. Community Bank, 148 Ill. App. 3d 248, 498 N.E.2d 843 (1986) (in which a mortgagor offered to deposit cash as consideration for the bank releasing a second mortgage on his residence, and, after the cash was deposited in a noninterest bearing account and the bank seized the money without the mortgagor's consent, the mortgagor brought a claim against the bank for breach of contract).

19. *See* cases cited *supra* note 16.

20. Contract law was designed to protect the reasonable expectations of the parties, as well as to ensure an efficient economic system. Diamond, *The Tort of Bad Faith Breach of Contract: When, If At All, Should It Be Extended Beyond Insurance Transactions?*, 64 Marq. L. Rev. 425, 437 & n.46 (1981). Contract damages are limited to economic losses that are foreseeable when the contract is formed, thus reducing uncertainty and encouraging efficient allocation of resources. *Id.* at 433-37. Because the cost of breach is known at formation, a breaching party can determine when the gain from breach will exceed the cost of compensating the aggrieved party for the breach. Speidel, *The Borderland of Contract*, 10 N. Ky. L. Rev. 163, 173 (1983). When the gain from the breach exceeds the value of performance, breach becomes profitable. *See* Diamond, *supra*, at 435 n.16. This doctrine, known as "efficient breach," emphasizes economic opportunities rather than the wrongfulness of breaching. *Id.* at 438.

21. Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854).

hopes of recovering both the "benefit of the bargain" and a large punitive award, typically bring claims under both a breach of contract claim and various tort theories.[22]

A common form of the breach of contract claim is the borrower's contention that the lender orally promised to extend a loan or other service.[23] If the promise is capable of performance within a year, the Statute of Frauds does not require it to be in writing.[24] Accordingly, a lender's failure to execute an oral promise that is capable of performance within one year presents a valid breach of contract claim.

Lenders typically rely on the parol evidence rule when faced with a borrower's claim of an oral agreement. The parol evidence rule provides that the unambiguous written terms of loan documents preempt oral agreements.[25] Thus, while the borrower may claim that a prior oral agreement existed, the loan documents are assumed to embody the entire agreement of the parties once they are signed.[26] Under the parol evidence rule, evidence of prior inconsistent terms is not admissible.[27] In contrast, evidence of subsequent oral agreements, and occasionally subsequent conduct, is admissible to show that a written agreement has been modified, or its terms waived.[28] Courts have not responded con-

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22. The larger awards recoverable under tort theories have led, in the opinion of a noted legal scholar, to "more or less inevitable efforts of lawyers to turn every breach of contract into a tort." W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 92, at 614 (4th ed. 1971), *quoted in* Iron Mountain Sec. Storage Corp. v. American Specialty Foods, 457 F. Supp. 1158, 1165 (E.D. Pa. 1978). Some courts have declined to apply tort claims in a lender-borrower context, despite the recent prevalence of tort claims against banks. *See Iron Mountain*, 457 F. Supp. at 1158 (holding that tort recovery was not appropriate under a claim for breach of the implied contractual duty of good faith and fair dealing when the breach involved an ordinary commercial contract); Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986) (refusing to find a tortious cause of action for breach of the good faith provisions of the Uniform Commercial Code (U.C.C.) because the U.C.C. does not provide such a remedy). Other courts have acknowledged that tort damages are recoverable for the breach of a commercial contract only in certain circumstances. *See* Rodgers v. Tecumseh Bank, 756 P.2d 1223 (Okla. 1988).

23. *Cf.* 999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985). Borrowers also have claimed breach of contract when the lender has reneged on a written commitment letter. *Id.*

24. *See* U.C.C. § 2-201 (1987).

25. *See id.* § 2-202; *see also* Special Project Note, *Written Agreements*, *infra*, at notes 1-57 and accompanying text.

26. *See* U.C.C. § 2-202 (1987).

27. *Id.*

28. *See, e.g.*, Varela v. Wells Fargo Bank, 15 Cal. App. 3d 741, 93 Cal. Rptr. 428 (1971) (past conduct of the bank waived its right to repossess without notice); Pierce v. Leasing Int'l, Inc., 142 Ga. App. 371, 235 S.E.2d 752 (1977) (creditor's acceptance of late payments waived its right to repossess without notice).

In cases in which inconsistent conduct by the lender does not constitute waiver, a "nonwaiver" provision generally has been present in the loan agreement. *See* Van Bibber v. Norris, 275 Ind. 555, 562, 419 N.E.2d 115, 120 (1981) (concerning a nonwaiver provision which stated that "[n]o waiver by the seller of any default shall be effective unless in writing, nor operate as a waiver of any other default nor of the same default on a future occasion"); *see also* Delta Diversified, Inc.

sistently to the question of modification. The following cases present two different views on modification.

In *Alaska Statebank v. Fairco*[29] the Alaska Supreme Court found that the parties had modified a loan agreement by their course of dealing.[30] Fairco borrowed from Alaska Statebank under two loan agreements.[31] Both loans were secured by the inventory and accounts receivable of Fairco's retail store, Clowntown.[32] If Fairco defaulted on either note, both notes would become due immediately.[33] Fairco made regular, although untimely, payments on the first note, but was unable to make its payments on the second note[34] and, consequently, began negotiations with the bank to extend the repayment schedule.[35] During the negotiations Fairco made a counterproposal to the bank, which would have extended repayment. Immediately after Fairco's counterproposal, one of the bank officers decided to proceed against the collateral.[36]

At trial the parties presented conflicting testimony about whether the bank accepted Fairco's proposal.[37] The trial court found that the bank, by its conduct and course of dealing, led Fairco to believe that the payments on the note were not currently due and that no default existed.[38] The court also found that Fairco's reliance on that belief was reasonable.[39] The Alaska Supreme Court affirmed the trial court's holding that the loan agreement had been modified and that Fairco was not in default when the bank repossessed the collateral.[40]

On similar facts a Florida appellate court in *Flagship National Bank v. Gray Distribution Systems, Inc.*[41] reached an opposite result. In *Flagship* the borrower, Gray, borrowed three hundred seventy-five

v. Citizens & S. Nat'l Bank, 171 Ga. App. 625, 320 S.E.2d 767 (1984) (holding that a waiver provision signed by the guarantors precluded them from asserting inconsistent bank conduct as a defense to the bank's action to recover amounts under a loan default).

29. 674 P.2d 288 (Alaska 1983).

30. *Id.* at 293.

31. *Id.* at 289.

32. *Id.* at nn.1 & 2.

33. *Id.* at 289.

34. *Id.*

35. *Id.* at 290.

36. *Id.*

37. *Id.* The trial judge accepted Fairco's version of the testimony, which tended to show that an agreement had been reached to extend repayment. *Id.*

38. *Id.*

39. *Id.* The trial court also noted that even if a default did exist, the bank was required to give notice before proceeding against the collateral. *Id.* at 292.

40. *Id.* at 292-93. The Alaska Supreme Court, in affirming the lower court, noted that "modification of a written contract may be effected either through subsequent conduct or oral agreements." *Id.* at 292.

41. 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986).

thousand dollars from Flagship and pledged its accounts receivable as security.[42] When the business began to deteriorate, Gray could not make its payments and Flagship declared the loan in default.[43] After demanding payment, which Gray could not make, Flagship restructured the loan under a "workout" agreement[44] by executing a new note increasing Gray's indebtedness to four hundred thousand dollars. This new loan agreement provided that the principal and unpaid interest would be payable on demand.[45] Despite the four hundred thousand dollar lending limit, Flagship extended approximately two hundred thousand dollars in excess of this limit.[46] When business continued to decline despite these efforts, Flagship gave Gray written notice of default and demanded payment in full.[47] Flagship then instituted an action to recover amounts Gray owed under the loan. In response, Gray asserted breach of contract as an affirmative defense and counterclaim.[48] The trial court found that Flagship's extension of credit beyond the lending limitation in the original agreement modified the agreement and bound Flagship to continue to extend credit beyond the limit.[49] Accordingly, the trial court held that Flagship's demand for payment breached the modified loan agreement.[50]

The appellate court reversed the trial court's decision because it found no modification or breach of the original agreement.[51] While the court agreed that a written contract may be modified by a course of dealing, it determined that when a course of dealing and the express terms of a contract conflict, the express terms control.[52] The court found that the express terms of Gray's loan providing for a credit limit of four hundred thousand dollars and payment on demand overrode any modifications that might have been inferred from the parties'

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42. *Id.* at 1338.

43. *Id.*

44. *Id.* A "workout" agreement is an out of court financial arrangement that restructures the dehtor's business. *See generally Business Loan Workouts 1983*, 309 P.L.I. COM. L. & PRAC. SER. (1983); *see also* Rosenberg, *An Overview of Workouts From the Perspective of the Institutional Lender*, 16 LOY. U. CHI. L.J. 1 (1984).

45. *Flagship*, 485 So. 2d at 1338.

46. *Id.* at 1338-39.

47. *Id.* at 1339.

48. *Id.* Flagship and Gray reached a settlement agreement regarding Flagship's right to possess Gray's collateral. The action proceeded to recover the amount of the loan not satisfied by liquidation of the collateral. Flagship obtained a partial summary judgment awarding it a deficiency judgment of $234,198.52. It was at this point that Gray was granted permission to file defensive pleadings. *Id.*

49. *Id.* at 1340.

50. *Id.*

51. *Id.* at 1340-41.

52. *Id.*; *see also* U.C.C. § 1-205(4) (1987).

course of dealings.[53]

Although the loan agreement in *Alaska Statebank* also contained express terms that were not followed strictly, the court found that negotiations to "workout" the loan had modified the agreement.[54] Lack of notice in *Alaska Statebank*[55] could distinguish that case from *Flagship*; however, the appellate court's finding of no modification in *Flagship* was based on its determination that express terms controlled course of dealing, rather than on the fact that the bank gave notice before instituting an action to repossess the collateral.[56] In addition, lack of notice was the basis for the *Alaska Statebank* court's finding of wrongful repossession, but it was not a factor in the determination that the loan agreement had been modified.[57] Thus, the fact that notice was present in *Flagship* and absent in *Alaska Statebank* does not account for the inconsistency of the decisions on the issue of modification. The uncertainty under this traditional theory of lender liability, however, pales in comparison to the confusion created by the emerging theories of lender liability.

III. Emerging Theories of Lender Liability

Most of the various tort and fiduciary principles wielded against lenders today as "new" theories of lender liability existed for centuries before plaintiffs began to apply them in a commercial setting. Even during the twentieth century, lenders were not the first to experience the impact of the substantial jury awards available under these theories. Insurance companies, doctors, accountants, and other professionals have all been subjected to the growing trend of the "business tort."[58]

While tort and fiduciary liabilities are not entirely new to lenders,[59] the frequency of their application has increased dramatically in the

53. *Flagship*, 485 So. 2d at 1340-41.

54. *Alaska Statebank*, 674 P.2d at 289, 292-93.

55. *Id.* at 292.

56. *See Flagship*, 485 So. 2d at 1340. A Wisconsin appellate court also found that a course of dealing by a bank (it used the synonymous phrase "course of performance") would not modify the bank's obligation with respect to overdrafts. Schaller v. Marine Nat'l Bank, 131 Wis. 2d 389, 388 N.W.2d 645 (Ct. App. 1986). The court in that case based its decision on grounds different than those used in either *Flagship* or *Alaska Statebank*. The *Schaller* court found that modification by course of dealing applied only to ongoing sales contracts and was not applicable to banking relationships. *Id.* at 400, 388 N.W.2d at 650.

57. *See Alaska Statebank*, 674 P.2d at 292-93.

58. *See Does Lender Liability Now Include Banker Malpractice?*, U.S. BANKER, May 1986, at 26; *see also* Coffey, *The Expansion of Lender Liability in Florida*, 40 U. FLA. L. REV. 85, 124 (1988); Note, *The Doctrine of Lender Liability*, 40 U. FLA. L. REV. 165, 200 (1988). For a discussion of medical liability, see Special Project Note, *Arbitration, infra*, at notes 153-93 and accompanying text.

59. *See, e.g.*, Earl Park State Bank v. Lowmon, 92 Ind. App. 25, 161 N.E. 675 (1928).

past few years. It has become common practice to advance at least one tort or fiduciary claim in any suit brought by or against a lender, regardless of the circumstances of the primary complaint.[60]

In order to recover successfully under a tort theory, a party must establish a duty of care owed by the lender to the borrower. Additionally, the borrower must show that the lender's breach of this duty proximately caused his injuries.[61] A lender also may be held liable to the borrower or other creditors for breaching its fiduciary duties.

A fiduciary duty may be established in several ways. Two of the more common ways to prove that a lender owed a fiduciary duty to a borrower are the control and special relationship[62] theories. If a fiduciary duty is established through either lender control of the borrower or a special advisory relationship with the borrower, a lender may be liable for abusing this fiduciary duty to the borrower. Lenders also may be subject to liability for breach of the duty of good faith.[63] This section will discuss lender liability based on breach of fiduciary duty, tortious lender liability, and lender liability for breach of the duty of good faith.

A. *Breach of Fiduciary Duty*

1. Control

Lenders often become involved, to some degree, in the management and operations of a troubled borrower. This type of control, even if expressly allowed by the loan agreement, can place the lender in a fiduciary relationship with the borrower.[64] Once the lender achieves fiduciary status, it may be liable under theories such as agency, instrumentality,

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60. *See, e.g.*, Sanchez-Corea v. Bank of Am., 38 Cal. 3d 892, 701 P.2d 826, 215 Cal. Rptr. 679 (1985) (claiming breach of contract, breach of implied covenant of good faith and fair dealing, fraud, disparagement of credit, interference with prospective economic advantage, promissory estoppel, negligence, and intentional infliction of emotional distress); Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986) (claiming fraud, breach of duty of good faith, and prima facie tort).

61. W. PROSSER, *supra* note 22, § 30, at 143.

62. *See infra* notes 104-34 and accompanying text.

63. U.C.C. § 1-203 (1987) (creating a contractual duty of good faith). The *Restatement (Second) of Contracts* also imposes a contractual duty of good faith in § 205. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) [hereinafter RESTATEMENT OF CONTRACTS]. Some courts recognize tortious liability for breaching the implied covenant of good faith and fair dealing. *See infra* notes 227-57 and accompanying text.

64. The lender also may be found to owe a fiduciary duty to the borrower's other creditors. *See, e.g.*, *In re* Beverages Int'l, Ltd., 50 Bankr. 273 (Bankr. D. Mass. 1985) (holding that the creditor's security interest was void, and that the creditor's claim was subordinated because the creditor breached a fiduciary duty owed as a result of control and decision-making authority over the debtor); Bergquist v. First Nat'l Bank (*In re* American Lumber Co.), 5 Bankr. 470 (Bankr. D. Minn. 1980) (stating that a lender's claim was subordinated because the lender used its power as a controlling creditor in a manner which injured other creditors).

and alter ego.[65]

Under the common-law theory of agency, lender liability is based upon the determination that a controlling lender has become a principal and the debtor has become its agent. As a principal, the lender must treat the debtor and other creditors fairly and impartially in matters related to the debtor.[66] The following case illustrates the application of agency principles in a debtor-creditor relationship.

In *A. Gay Jenson Farms Co. v. Cargill, Inc.*[67] the Minnesota Supreme Court held that the financial and managerial control exercised by a creditor established an agency relationship between the debtor and creditor. The *Jenson* court defined agency as "the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."[68] The court required that an agreement exist between the parties before an agency relationship could be found.[69] An explicit contract between the parties was not necessary, however, because the agreement could be proved by circumstantial evidence, such as a course of dealing.[70]

Jenson involved the financial failure of a grain elevator operation, Warren Grain & Seed Co. (Warren).[71] Warren's lender, Cargill, Inc. (Cargill), had financed Warren's entire business for more than fourteen years. As part of the financing agreement, Cargill was given a right of first refusal to purchase Warren's grain, the right to inspect Warren's books, the right to approve dividend declarations and other stock transactions, and the right to approve capital improvements in excess of five thousand dollars.[72] The agreement also prohibited Warren from guaranteeing debts or encumbering assets without Cargill's consent.[73]

In finding that Cargill's involvement constituted de facto control of Warren's business, the court emphasized those terms of the financing agreement listed above as well as the following factors: Cargill's constant recommendations and criticism regarding Warren's finances, officers' salaries, and inventory; Cargill's right to enter Warren's premises

65. Liability also has been imposed on a lender for lack of control. Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968). In *Connor* a construction lender was found liable to home purchasers for construction defects. The court held that tbe lender's financing activities imposed a duty on the lender to exercise reasonable care to prevent the sale of defective homes. The lender was liable for failing to use its influence and control as the construction lender to ensure that its borrower built nondefective homes. *Id.*

66. *See infra* note 75.

67. 309 N.W.2d 285 (Minn. 1981).

68. *Id.* at 290.

69. *Id.*

70. *Id.*

71. *Id.* at 288.

72. *Id.*

73. *Id.*

and conduct periodic checks and audits; Cargill's name on all of Warren's financial correspondence; and Cargill's ability to terminate Warren's operating capital.[74] Citing the *Restatement (Second) of Agency*,[75] the *Jenson* court concluded that Cargill was liable as a principal for the business deeds of its debtor, Warren.[76]

Although related to the theory of agency, the instrumentality or alter ego theory relies on different factual underpinnings. While both theories entail control by the lender that goes beyond an ordinary debtor-creditor relationship, the distinction between the two centers on the amount of control and involvement required to impose a fiduciary duty on the lender. Under the instrumentality or alter ego theory the creditor must assume "actual, participatory, total control of the debtor."[77] A creditor must dominate a debtor's business so completely that either the creditor becomes the debtor's alter ego, or the debtor becomes the creditor's instrument. Under the agency theory, as shown in *Jenson*, a slightly lesser degree of involvement is necessary to find an agent-principal relationship. The following case illustrates the degree of control needed to create liability under the instrumentality or alter ego theory.

In *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*[78] ten creditors of a reorganized corporation sought to hold another creditor liable for the corporation's debts on the ground that the debtor corporation was an instrumentality or alter ego of the defendant creditor.[79] In order to find a duty based on the theory of instrumentality or alter ego, the Fifth Circuit Court of Appeals required a showing that the lender was in "actual, participatory, [or] total control" of the

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74. *Id.* at 291.

75. RESTATEMENT (SECOND) OF AGENCY § 14 O (1958) [hereinafter RESTATEMENT OF AGENCY] (stating that a "creditor who assumes control of his debtor's business for the mutual henefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business"). An accompanying comment to the *Restatement* further provides:

> A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as any principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

Id. § 14 O comment a.

76. *Jenson*, 309 N.W.2d at 290.

77. Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, 1105 (5th Cir. 1973); *see infra* notes 78-84 and accompanying text.

78. 483 F.2d 1098 (5th Cir. 1973).

79. *Id.* at 1101.

management of the debtor's affairs.[80] Applying this standard of "total" control, the court declined to charge the lender with responsibility for the borrower's debts.[81] Although the lender was involved in the borrower's financial management, liquidation of assets, and contractual obligations, the court found insufficient evidence to support a jury decision that the debtor had "no separate mind, will or existence of its own."[82] Thus, the *Krivo* court required a higher degree of involvement than the court in *Jenson*, which found an agency relationship based on a definition of agency requiring "consent by one person to another that the other shall act on his behalf and subject to his control."[83]

The lender in *Krivo* might have been charged with liability under the agency standard used in *Jenson*. Likewise, the lender in *Jenson* may have escaped liability by failing to satisfy the total control test for instrumentality used in *Krivo*. Although both cases involved lenders which participated to some degree in their borrower's financial management, the courts applied different standards to determine liability based on control. Because of these differing standards, it is difficult for lenders to determine when they are risking liability by exerting too much control over their borrowers. Additionally, some courts have chosen not to apply agency or instrumentality theories in a creditor-debtor context and instead have based liability on various other factors which these courts have deemed to indicate excessive control.

Ownership of the borrower's stock is one factor that may indicate enough lender control to create a fiduciary duty. Although stock ownership alone does not constitute domination of a borrower,[84] inequitable use of that ownership or ownership in addition to other controlling conduct may indicate excessive control. For example, in *In re Process-Manz Press, Inc.*[85] Armstrong, the creditor, held more than ninety percent of Process-Manz's stock as collateral for its loan. Armstrong used this control to amend the articles of incorporation so that preferred stock could be redeemed.[86] Armstrong then redeemed approximately 280,000 shares of preferred stock, which eliminated two million dollars of Process-Manz's working capital.[87] Armstrong took this action although Process-Manz already was experiencing difficulty in paying its obligations.[88] An Illinois district court upheld the referee in bank-

80. *Id.* at 1105.
81. *Id.* at 1109.
82. *Id.*
83. *Jenson*, 309 N.W.2d at 290; *see supra* notes 67-76 and accompanying text.
84. *Krivo*, 483 F.2d at 1109.
85. 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd on other grounds*, 369 F.2d 513 (7th Cir. 1966).
86. *Id.* at 338-39.
87. *Id.* at 339.
88. *Id.* at 348.

ruptcy's order to subordinate the lender's claim against Process-Manz to the claims of the unsecured creditors.[89] The *Process-Manz* court found that Armstrong was essentially an owner and, as such, owed a fiduciary duty to Process-Manz's other creditors.[90]

In *In re American Lumber Co.*,[91] another case involving stock ownership, the lender did not directly use its ownership interest to control the borrower. The stock ownership was an additional factor indicating excess control, but it is doubtful that the stock holdings alone would have resulted in a fiduciary status.[92] The *American Lumber* court emphasized control of operations in its finding of excessive lender control.[93] A lender's control of its borrower's operations can lead to a finding of liability under an agency or instrumentality theory; however, a court need not use either of these theories directly.

In *American Lumber* the lender, a controlling creditor, foreclosed on its security interest in equipment, inventory, and receivables, effectively taking over the debtor's plant.[94] The lender received all of the debtor's mail, including payments on accounts receivable, and approved all payments to other creditors.[95] The lender forced the debtor to terminate all employees except a minimal crew kept on to assist with liquidation.[96] The corporate officers' salaries were cut to one-sixth of their prior levels.[97] The Minnesota district court found that the lender had abused its power as a controlling creditor, thereby injuring the other creditors of the debtor.[98] Thus, the court subordinated the claims of the lender to those of the other creditors.[99]

As these cases illustrate, control liability need not be grounded in an agency or instrumentality theory. Factors such as control of stock, selection of management, involvement in daily operations or financial management, and use of the borrower's business to achieve a purpose of the lender all can show excessive control resulting in a fiduciary duty to the borrower and other creditors.[100] Additionally, borrowers can use

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89. *Id.* at 349.
90. *Id.*
91. Bergquist v. First Nat'l Bank (*In re* American Lumber Co.), 5 Bankr. 470 (Bankr. D. Minn. 1980).
92. *Id.* at 478.
93. *Id.*
94. *Id.* at 473-74.
95. *Id.*
96. *Id.* at 474.
97. *Id.* at 478.
98. *Id.*
99. *Id.*
100. *See generally* Miller, Calfo & Levy, *The Fiduciary Duty of Lenders Through Excessive Involvement or Control Over Borrowers in Lender Liability Cases*, 434 P.L.I. COM. L. & PRAC. SER. 161 (1987).

control factors to establish liability under a tort theory, such as interference with a business purpose.[101] Some commentators believe that common-law tort theories, because they are less complex than control theories,[102] perhaps provide clearer guidelines for both lenders and borrowers. The various standards represented by the agency, instrumentality, and other control theories show the need for more definite guidelines. Lenders which find it too difficult to weigh the risks involved in assisting a troubled borrower may refuse to extend help at all. This refusal not only deprives the borrower of a chance to recover, but also decreases junior creditors' chances to receive a larger part of their claims.[103]

2. Special Relationships

Even when a lender is not involved substantially in its borrower's business, thus making control liability unlikely, other actions by the lender still may expose it to liability based on the existence of a fiduciary duty. This situation can arise when the lender is involved in a special relationship of trust or confidentiality with its borrower.[104] If the relationship is such that it is reasonable for the borrower to rely on the lender to protect the borrower's interest, the lender has a fiduciary duty to the borrower.[105] A lender that takes advantage of a borrower's reliance that the lender will further the borrower's interest will be liable for breach of its fiduciary duty to the borrower.

Two early cases involving the imposition of fiduciary duties on lenders are *Earl Park State Bank v. Lowmon*[106] and *Stewart v. Phoenix*

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101. *See infra* notes 172-81 and accompanying text.

102. *See* Ebke & Griffin, *supra* note 1, at 795.

103. *See infra* notes 262-66 and accompanying text.

104. *Black's Law Dictionary* defines a fiduciary relation as follows:

> A relation subsisting between two persons in regard to a business, contract, or piece of property, or in regard to the general business or estate of one of them, of such a character that each must repose trust and confidence in the other and must exercise a corresponding degree of fairness and good faitb. Out of such a relation, the law raises the rule that neither party may exert influence or pressure upon the other, take selfish advantage of his trust, or deal with the subject-matter of the trust in such a way as to benefit himself or prejudice the other except in the exercise of the utmost good faith and with the full knowledge and consent of that other, business shrewdness, hard bargaining, and astuteness to take advantage of the forgetfulness or negligence of another being totally prohibited as between persons standing in such a relation to each other. Examples of fiduciary relations are those existing between attorney and client, guardian and ward, principal and agent, executor and heir, trustee and *cestui que trust*, landlord and tenant, etc.

BLACK'S LAW DICTIONARY 564 (5th ed. 1979) [hereinafter BLACK'S].

105. RESTATEMENT OF AGENCY, *supra* note 75, §§ 1, 13; RESTATEMENT (SECOND) OF TRUSTS §§ 2, 170 comment (a) (1959).

106. 92 Ind. App. 25, 161 N.E. 675 (1928).

National Bank.[107] In *Earl Park* a bank persuaded its customer to borrow from the bank and to loan the borrowed funds to another bank customer who was in debt to the bank. The borrower was a farmer with little business experience who relied greatly on the advice he received from the bank's manager on business matters. The manager never told the farmer that the other customer planned to use the borrowed funds to pay off his debt to the bank. An Indiana court of appeals found that the bank was liable to the farmer for breaching its fiduciary duty to disclose.[108]

In *Stewart* circumstances similar to those in *Earl Park* led the Arizona Supreme Court to find a fiduciary duty of disclosure.[109] The bank in *Stewart* acted as a farmer's financial advisor for twenty-three years and routinely loaned him funds on an unsecured basis.[110] In 1931 the bank requested that the farmer give the bank a mortgage on real estate that the farmer owned as security for an already existing loan.[111] The bank told the farmer that it was taking this mortgage merely as a formality to satisfy record keeping requirements and that it would not foreclose on the property.[112] Despite these representations, the bank foreclosed.[113]

The *Stewart* court acknowledged that "ordinarily no confidential relation arises" out of the relationship between a bank and its depositor; however, the relationship in the instant case was "far beyond that of a mere debtor and creditor."[114] The court discussed the nature of modern commercial transactions and concluded that fiduciary standards were appropriate in certain banking relationships.[115] Thus, the

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107. 49 Ariz. 34, 64 P.2d 101 (1937).
108. *Earl Park*, 92 Ind. App. at 38, 161 N.E. at 679.
109. *Stewart*, 49 Ariz. at 34, 64 P.2d at 101.
110. *Id.* at 40, 64 P.2d at 104.
111. *Id.*
112. *Id.* at 41, 64 P.2d at 104.
113. *Id.* at 41, 64 P.2d at 105.
114. *Id.* at 44, 64 P.2d at 106.
115. *Id.* at 45-46, 64 P.2d at 106. The court stated:

It may have been that generations ago, when most commercial transactions were for cash, or at least consisted merely of personal obligations between vendor and purchaser, and the highly complicated modern structure of credit and corporate securities did not exist, that banks, which were originally merely places of security where a man might deposit his cash and valuables, did not, as such, hold any greater confidential relations with their clients than those between any other two businessmen. But times have changed. It is almost inconceivable that any man should engage in financial transactions of any magnitude in the modern time without having recourse to some bank not only as a place of safety to keep his money, but as a place where he might secure loans to conduct his business. It is notorious that modern banks, before they make a loan of any extent, make a rigid investigation of the business of their customer, and even the purpose for which the loan is to be used, basing their action thereon. It is equally notorious that in many, if not most, cases an investor will consult his bank before committing himself, believing that he has the right to rely upon the advice of its

court found that a confidential relationship existed and that the bank had a duty to disclose its true intentions regarding the mortgage.[116]

Many recent cases involving a breach of fiduciary duty also have focused on the duty to disclose.[117] Courts that find a fiduciary relationship between a bank and its borrower generally base their holdings on the existence of a special relationship. As in *Stewart*, something beyond an ordinary creditor-debtor relationship is necessary.[118]

One of the most frequently cited cases concerning this issue is the Minnesota Supreme Court's decision in *Klein v. First Edina National Bank*.[119] In *Klein* a woman brought suit when her bank foreclosed on stock she had pledged as security for a loan to her employer. The bank failed to inform her that her employer already owed the bank 9250 dollars on another loan and that the stock would be the only collateral for both loans.[120] Although the woman had been a customer of the bank for twenty years during which time she had maintained several savings and checking accounts, rented safety deposit boxes, and obtained a mortgage, the court found that the bank was not under a fiduciary duty of disclosure.[121] The requisite special relationship was lacking because the bank was not aware that the woman was relying on the bank to look after her interests and to advise her.[122]

Several courts have adopted the *Klein* approach and held that a

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officers as being given in good faith. It has even become a common, if not practically a universal, practice, for banks to advertise that they are desirous of performing many services always held to be confidential in their nature, such as trustee, executor, administrator, and the like, for all who care to do business with them. So much has this become the custom that in many cases they have attempted to extend such services to the relation of attorney and client, and it has required legislation in many states to prevent this. We are of the opinion that, in view of all these modern business practices, of which we cannot be ignorant, that where it is alleged a bank has acted as the financial advisor of one of its depositors for many years, and that the latter has relied upon such advice, it is a sufficient allegation that a confidential relationship in regard to financial matters does exist and that, if it is proved, the bank is subject to the rules applying to confidential relations in general. This of course, does not mean that the bank may not make a reasonable legitimate profit from the client, but it does mean that it cannot appeal to the doctrine of *caveat emptor*, and that it must disclose fairly and honestly to the client all the facts which might be presumed to influence him in regard to his actions.

Id.

116. *Id.* Although the court found that the bank had breached its confidential relationship with the farmer, the farmer did not prevail on his claim; a prior determination against the farmer served as res judicata to prevent him from winning his claim. *Id.* at 47-49, 64 P.2d at 107-08.

117. For a discussion of the related claims of fraud and negligent misrepresentation, see *infra* text accompanying notes 152-60.

118. *Stewart*, 49 Ariz. at 44, 64 P.2d at 106.

119. 293 Minn. 418, 196 N.W.2d 619 (1972).

120. *Id.* at 420-21, 196 N.W.2d at 621-22.

121. *Id.* at 422, 196 N.W.2d at 623. The court stated that "[t]he fact that plaintiff had done business with defendant for nearly 20 years could not by itself place defendant in a confidential relation to plaintiff." *Id.*

122. *Id.*

bank will not have a fiduciary duty to inform the customer unless the bank knows, or should know, that the customer is relying reasonably on the bank to protect the customer's interests.[123] Other jurisdictions, however, have found a confidential relationship on similar facts, although the bank had not consciously assumed a fiduciary duty.[124]

In *Barnett Bank v. Hooper*,[125] for example, the bank failed to disclose a suspected check kiting scheme to a borrower who borrowed funds to invest with the suspected kiter. The borrower intended to invest the borrowed funds in a tax shelter which he originally had invested in a year before. When the original investment was made, the bank had told the borrower that the investment was sound. To complete the second investment, the borrower and the suspected kiter called the bank and arranged for ninety thousand dollars of borrowed funds to be deposited into the suspected kiter's account. About ten days later, the check kiting was confirmed, but because the proceeds of the loan had been deposited into the kiter's account, the bank was able to close the account without a loss. The court found that the bank's initial recommendation of the investment coupled with the borrower's long relationship with the bank[126] was enough to create a confidential relationship between the institution and its customer.[127] The dissent,

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123. *See, e.g.*, Kurth v. Van Horn, 380 N.W.2d 693 (Iowa 1986) (holding that although the customer placed his trust and confidence in the bank, there was no evidence to show that the bank was aware of the customer's reliance and, thus, no fiduciary duty); *see also* Denison State Bank v. Madeira, 230 Kan. 684, 696, 640 P.2d 1235, 1243-44 (1982) (finding that the defendant was competent and able to protect his own interests and that he could not impose a fiduciary relationship without unilaterally a conscious assumption of such duties by the bank); Stenberg v. Northwestern Nat'l Bank, 307 Minn. 487, 488, 238 N.W.2d 218, 219 (1976) (determining that Mr. Stenberg was a businessman, "capable of independent judgment," and concluding that there was no evidence to support a finding of a special duty owed by the bank); Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St. 2d 282, 287, 390 N.E.2d 320, 323 (1979) (stating that advice given by the bank was insufficient to create a fiduciary relationship because neither party had, or should have had, a reasonable expectation that the bank acted primarily for the benefit of the borrower).

124. *See, e.g.*, Barnett Bank v. Hooper, 498 So. 2d 923 (Fla. 1986); *infra* notes 125-28 and accompanying text; *see also* Barrett v. Bank of Am., 183 Cal. App. 3d 1362, 1369, 229 Cal. Rptr. 16, 20-21 (1986) (finding that a fiduciary duty based on the borrowers' trust and confidence in the loan officer and on their reliance on the officer's advice on mergers); Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554 (1985) (determining that the relationship between a bank and its depositor is at least "quasi-fiduciary"); Deist v. Wachholz, 208 Mont. 207, 218-20, 678 P.2d 188, 194-95 (1984) (finding a fiduciary duty to disclose based on the bank's role as the plaintiff's advisor).

125. 498 So. 2d 923 (Fla. 1986).

126. *Id.* at 924. The borrower had been doing business with the bank for more than eight years. *Id.*

127. *Id.* at 924-25. The court stated:

> [W]e find that where a bank becomes involved in a transaction with a customer with whom it has established a relationship of trust and confidence, and it is a transaction from which the bank is likely to benefit at the customer's expense, the bank may be found to have assumed a duty to disclose facts material to the transaction, peculiarly within its knowledge, and not

following the *Klein* position, argued that no fiduciary duty should have been found absent a conscious acceptance of the duties of a fiduciary on the part of the bank.[128]

Although a majority of cases that involve a fiduciary duty based on a special relationship concern a lender's alleged duty to disclose, several other issues can arise which require a fiduciary duty to be shown. For example, in *Atlantic National Bank v. Vest*[129] a Florida appellate court held that a fiduciary duty arose when a customer asked a bank loan officer a legal question.[130] The customer's inquiry placed the bank in a position of superiority and influence and, thus, imposed a duty on the bank to answer in good faith.[131] The court, however, found that the bank discharged its duty when one of its loan officers stated that she did not know the answer to the question.[132]

Other issues involving a fiduciary duty based on a special relationship include a construction lender's duty to disclose potential flooding to a purchaser,[133] and a lender's duty to keep the contents of a loan application confidential.[134] As in cases involving a fiduciary duty imposed because of a lender's excessive control, however, the different standards used to determine whether a fiduciary duty exists based on a special relationship leave banks with few guidelines with which to determine their risks in a given situation. In the jurisdictions that follow *Klein*, banks will have a fiduciary duty to their customers in fewer situations than in those jurisdictions that do not require banks consciously to assume such duties. Additionally, when the circumstances involve an issue other than the duty to disclose, even fewer guidelines exist, and often the case will be one of first impression.

Because of the complexity of the fiduciary theories and the scarcity of definite guidelines, plaintiffs have begun to bring claims against lenders under tort theories. Unlike the fiduciary actions, most of the tort theories are well defined and have clearly established elements. The next section examines the different tort theories that have been brought

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otherwise availahle to the customer.

Id. at 925.

128. *Id.* at 927-29.

129. 480 So. 2d 1328 (Fla. Dist. Ct. App. 1985).

130. *Id.* at 1333. Although the plaintiff was a long-time customer of the bank, the court did not expressly consider this fact in finding a fiduciary duty. *Id.* at 1330, 1333.

131. *Id.* at 1332-33.

132. *Id.* When the loan officer could not answer the question, she called the plaintiff's insurance agent and relayed the agent's answer to the defendant. The information was not correct and formed the basis of the plaintiff's complaint against the bank for misrepresentation. *Id.* at 1330.

133. Camp v. First Fed. Sav. & Loan, 12 Ark. App. 150, 671 S.W.2d 213 (1984).

134. Djowharzadeh v. City Nat'l Bank & Trust Co., 646 P.2d 616 (Okla. Ct. App. 1982). This duty could cause a direct conflict witb the duty to disclose information about another customer foımd in cases such as *Barnett*, discussed *supra* notes 125-28 and accompanying text.

against lenders in recent years.

B. Tortious Lender Liability

Tort law protects members of society from unreasonable actions of others by setting certain minimum standards of conduct.[135] When conduct by a member of society does not meet these standards, tort law punishes the offender to deter others from performing similar acts in the future.[136] Thus, when a bank's conduct falls below the standards of reasonable conduct and injures a borrower or other customer of the bank, tort remedies are imposed to compensate the injured party and to discourage other banks from conducting similar transactions in the future.

State National Bank v. Farah Manufacturing Co.[137] is a leading tort case in lender liability. Farah Manufacturing Company (FMC) began in 1919 as a family-owned apparel manufacturer.[138] William J. Farah (Farah) was the chief executive officer of FMC from 1964 until 1976, when the Board of Directors demanded that he step down following a strike, a nationwide boycott, and substantial losses.[139] After his replacement, FMC executed a secured loan agreement with three lenders (the banks).[140] The loan agreement included a clause prohibiting a change in management "which any two Banks shall consider, for any reason whatsoever, to be adverse to the interests of the Banks."[141]

When FMC continued to lose money, Farah requested that the Board re-elect him as chief executive officer.[142] Fearful that Farah's election would trigger a default in the loan agreement, the Board instructed Farah to present his plan to the banks.[143] The banks responded by advising the Board in a letter that Farah's election as chief executive officer was unacceptable and that the banks would not waive their rights under the management change clause if Farah was elected.[144] Furthermore, representatives of the banks threatened to "bankrupt the company and . . . padlock it the next day" if Farah was elected.[145] At the time the letter was sent and the threats made, however, the banks either had decided previously not to declare a default

135. *See* W. PROSSER, *supra* note 22, § 92, at 613.
136. Diamond, *supra* note 20, at 427 n.7.
137. 678 S.W.2d 661 (Tex. Ct. App. 1984).
138. *Id.* at 667.
139. *Id.* at 670.
140. *Id.* at 667.
141. *Id.*
142. *Id.* at 670.
143. *Id.*
144. *Id.* at 672.
145. *Id.* at 673.

under the loan agreement, or had not reached a decision on the matter.[146]

As a result of the banks' warnings, Farah withdrew his election proposal. Thereafter, the election resulted in a board comprised primarily of individuals who were affiliated with or proposed by the banks. Despite efforts of the newly elected Board, FMC's financial condition continued to falter.[147] When FMC's position became desperate, Farah initiated a successful proxy fight which led to the election of a board that reinstated him as chief executive officer.[148] Within a short time, FMC began to prosper under Farah's direction.[149]

After Farah's return FMC filed suit against the banks for damages incurred during his absence. At trial, the jury found that the lenders had committed acts of fraud, duress, and interference, and awarded more than eighteen million dollars in damages to FMC.[150] On appeal the damage award was modified and affirmed.[151]

1. Fraud

While the specific elements of the tort of fraud are controlled by state law, generally, a party must show that the speaker knowingly or recklessly made a false, material representation on which the party relied and, as a consequence, was injured.[152] Furthermore, a representation that is capable of two interpretations, one which is known to be false and the other which is known to be true, also may comprise a fraudulent misrepresentation.[153] FMC's claim of fraud, for example, focused on a letter which stated that the banks would not waive their

146. *Id.* at 686.
147. *Id.* at 676-79.
148. *Id.* at 679.
149. *Id.* at 679-80.
150. *Id.* at 667.
151. *Id.* at 699. The judgment was reduced from $18,947,348.77 to $18,647,243.77. *Id.*
152. *See id.* at 681 (citing Custom Leasing, Inc. v. Texas Bank & Trust Co., 516 S.W.2d 138, 143 (Tex. 1974)); *see also* RESTATEMENT (SECOND) OF TORTS § 525 (1977) [hereinafter RESTATEMENT OF TORTS]. The *Restatement* states:

> One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.

Id.

153. RESTATEMENT OF TORTS, *supra* note 152, § 527. Section 527 of the *Restatement* states:

> A representation that the maker knows to be capable of two interpretations, one of which he knows to be false and the other true is fraudulent if it is made:
> (a) with the intention that it be understood in the sense in which it is false, or
> (b) without any belief or expectation as to how it will be understood, or
> (c) with reckless indifference as to how it will be understood.

Id.

rights under the management change clause if Farah was elected, as well as on the banks' threats to bankrupt and padlock FMC.[154] The letter and threats did not convey the banks' true intentions, however, because the banks either had decided not to declare a default, or had not reached a decision on the matter. The appellate court upheld the jury's finding of fraud stating that the banks had made a promise which they did not intend to perform.[155]

Lenders also may be held liable under the related tort theory of negligent misrepresentation. Generally, to succeed on a claim of negligent misrepresentation, a party must show that the representor: (1) intentionally made a material misrepresentation, or (2) failed to exercise due care when he made the material misrepresentation, or (3) omitted a fact on which the party relied and by which the party was injured.[156] For example, in *Crystal Springs Trout Co. v. First State Bank*[157] the Montana Supreme Court held a lender liable for assuring the shareholders of a partially destroyed trout farm that interim financing was available. The *Crystal Springs* court found that the bank's failure to provide the promised financing was a negligent misrepresentation that proximately caused the failure of the corporation.[158] Likewise, in

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154. *See supra* notes 144-45 and accompanying text.

155. *Farah*, 678 S.W.2d at 682. For other cases involving fraud, see: General Motors Acceptance Corp. v. Central Nat'l Bank, 773 F.2d 771 (7th Cir. 1985) (stating that fraud existed when a lender made representations to a third party about one of the lender's customers that created a false impression of the customer's financial soundness); Stirling v. Chemical Bank, 382 F. Supp. 1146 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975) (finding that fraud existed when officers and directors of the debtor company resigned their positions in reliance on the lenders' representations that they would make further loans and would not call the outstanding loans of the company); Sanchez-Corea v. Bank of Am., 38 Cal. 3d 892, 701 P.2d 826, 215 Cal. Rptr. 679 (1985) (finding fraud when a lender made representations that future financing might be forthcoming after an assignment of accounts receivable, when in fact the lender already had determined not to extend further loans); Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986) (in which the plaintiff claimed that silence on the part of the lender was intended as a representation that the plaintiff's note would be renewed, and the court dismissed the claim because the elements of reliance and proximate cause were lacking); and Citibank v. Plapinger, 66 N.Y.2d 90, 485 N.E.2d 974, 495 N.Y.S.2d 309 (1985) (foreclosing a claim of a lender's fraudulent inducement to sign a guarantee because of the "absolute and unconditional" language in the guarantee).

156. Berkline Corp. v. Bank of Miss., 453 So. 2d 699, 702 (Miss. 1984). Negligent misrepresentation is essentially a subset of the tort of fraud that imposes liability when the representor makes the representation without exercising due diligence and reasonable care.

157. 732 P.2d 819 (Mont.), *modified*, 736 P.2d 95 (1987).

158. *Id.* at 824. For other cases involving a lender's negligent misrepresentation, see: Atlantic Nat'l Bank v. Vest, 480 So. 2d 1328 (Fla. Dist. Ct. App. 1985) (stating that a loan officer's conveyance of incorrect information did not constitute negligent misrepresentation when the plaintiff knew that the information was not the officer's opinion or the opinion of the bank); Danca v. Taunton Sav. Bank, 385 Mass. 1, 429 N.E.2d 1129 (1982) (finding negligent misrepresentation when bank officials negligently failed to disclose irregularities in a house plan purchased by the mortgagors for the purpose of verifying that the location of the house tbey were to purcbase com-

Banker's Trust Co. v. Steenburn[159] a lender was held liable for negligent misrepresentation when it failed to exercise reasonable care in promising to loan money on a corporation's purchase orders.[160]

2. Duress

Duress occurs when one party wrongfully threatens another party, depriving the threatened party of the exercise of its free will and causing it to do that which it otherwise would not do.[161] Typically, duress, or business compulsion, is raised as a defense to avoid contractual liability.[162] Some courts, however, permit plaintiffs to assert duress as an affirmative tort. The borrower in *Farah*, for instance, affirmatively and successfully argued duress.

FMC's claim for duress, like its fraud claim, focused on the letter concerning the lenders' refusal to waive default and on their threats concerning the bankruptcy and padlocking of FMC. Although the lenders had a legal right to declare a default if Farah was elected,[163] the lenders' pre-election threats and warnings were designed to manipulate the election unlawfully. The court found that the lenders' threats to enforce legal rights were made in bad faith and, thus, constituted actionable duress.[164]

Pecos Construction Co. v. Mortgage Investment Co.[165] provides another example of an injured borrower asserting duress as an affirmative

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plied with zoning laws); and Berkline Corp. v. Bank of Miss., 453 So. 2d 699 (Miss. 1984) (finding that the lender could incur liability under the theory of negligent misrepresentation if it had not exercised reasonable care and diligence in dispensing information regarding the credit worthiness of one of its customers).

159. 95 Misc. 2d 967, 409 N.Y.S.2d 51 (Sup. Ct. 1978).

160. *Id.* at 991-93, 409 N.Y.S.2d at 66-67.

161. *See* 13 S. Williston, A Treatise on the Law of Contracts § 1602 (3d ed. 1970). The elements of common-law duress generally include:

> (1) . . . a threat to do some act which the party threatening has no legal right to do. (2) [The] threat must be of such character as to destroy the free agency of the party to whom it is directed . . . overcom[ing] his will and caus[ing] him to do that which he . . . was not legally bound to do. (3) The restraint caused by such threat must be imminent. (4) It must be such that the person to whom it is directed has no present means of protection.

Farah, 678 S.W.2d at 684 (quoting Dale v. Simon, 267 S.W. 467, 470 (Tex. Civ. App. 1924)). Hard bargaining or the existence of financial pressures alone will not constitute duress. Continental Ill. Nat'l Bank & Trust Co. v. Stanley, 606 F. Supp. 558, 562 (N.D. Ill. 1985).

162. *See, e.g.*, Rich & Whillock, Inc. v. Ashton Dev., Inc., 157 Cal. App. 3d 1154, 204 Cal. Rptr. 86 (1984); Mitchell v. C.C. Sanitation Co., 430 S.W.2d 933, 936 (Tex. Civ. App. 1968).

163. *Farah*, 678 S.W.2d at 686.

164. *Id.* at 684-86. The court found that the lenders acted in bad faith by threatening to declare a default at a time when FMC was not in default and was fully able to make repayment. The court focused on "whether the creditor's attempt to accelerate stemmed from a reasonable, good-faith belief that its security was about to become impaired." *Id.* at 685 (citing Sheppard Fed. Credit Union v. Palmer, 408 F.2d 1369 (5th Cir. 1969)).

165. 80 N.M. 680, 459 P.2d 842 (1969).

tort. In *Pecos* a lender agreed to furnish interim financing for the construction of a housing project.[166] After Pecos had expended substantial sums on the project, however, the lender refused to furnish the financing unless Pecos agreed to pay a twelve thousand dollar debt the lender owed to an unrelated third party.[167] The New Mexico Supreme Court found that Pecos's agreement to pay the debt was extracted wrongfully and constituted duress.[168]

Most jurisdictions recognize the tort of intentionally causing emotional distress, which is superficially related to duress. This cause of action exists when "[o]ne who by extreme and outrageous conduct intentionally or recklessly causes severe emotional distress to another."[169] In *Sanchez-Corea v. Bank of America*[170] the California Supreme Court held a lender liable for intentional infliction of emotional distress when the bank first had decided not to make additional loans to the borrowers and then publicly ridiculed the borrowers by using profanities, pointing at them and laughing about their financial plight.[171]

3. Interference with Advantageous Relations

Historically, a claim for tortious interference arose when a third party intentionally and improperly interfered with the performance of a contract by causing one of the parties to the contract not to perform.[172] The *Farah* court expanded the interference theory beyond interference with an existing or prospective contract to include the governance process of corporations and their shareholders. FMC based its claim of interference on the lenders' actions rejecting Farah as a candidate for chief executive officer, forcing Farah's resignation as chief executive of-

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166. *Id.* at 681, 459 P.2d at 843.

167. *Id.* at 682, 459 P.2d at 844.

168. *Id.*

169. RESTATEMENT OF TORTS, *supra* note 152, § 46.

170. 38 Cal. 3d 892, 701 P.2d 826, 215 Cal. Rptr. 679 (1985).

171. 38 Cal. 3d at 908-09, 701 P.2d at 837-38, 215 Cal. Rptr. at 691. *But see* Kruse v. Bank of Am., 202 Cal. App. 3d 38, 66-68, 248 Cal. Rptr. 217, 234-35 (1988) (holding that a bank official's statements to others concerning a real estate broker's "guts" in selling her mother's house did not rise to the level of outrageous conduct necessary for intentional infliction of emotional distress); Noonan v. First Bank Butte, 740 P.2d 631, 635 (Mont. 1987) (holding that absent a showing of physical or mental injury, mental distress is compensable only if the conduct substantially invades a legally protected interest and causes a significant impact on the plaintiff).

172. RESTATEMENT OF TORTS, *supra* note 152, § 766. The *Restatement* notes:

> One who intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.

Id.; *see also* 45 AM. JUR. 2D *Interference* § 1 (1969) (stating that "the theory of the tort of interference is that the law draws a line beyond which no member of the community may go in intentionally intermeddling with the business affairs of others").

ficer, packing the Board with representatives of the lenders, and supporting the proxy fight against Farah. The court found that FMC had a right to have its affairs managed by competent, loyal directors and officers chosen through the corporate election process and that the lenders had interfered impermissibly with this right.[173]

Melamed v. Lake County National Bank[174] shows the importance of a horrower's right to manage his own business. In *Melamed* the Sixth Circuit Court of Appeals found sufficient evidence of tortious interference to submit the claim to the jury when a lender instituted a plan that required the borrower to reduce the salary of its president by fifty percent, to replace its accountant with one chosen by the lender, and to approve all payments through the lender.[175] Additionally, the lender prepared a "[Thirteen]-Point Program" to help salvage everything possible from the borrower.[176] The court rejected the lender's defense that such actions were typical and necessary in workout situations.[177]

On the other hand, the Oklahoma Supreme Court in *Del State Bank v. Salmon*[178] held that a party may have a privilege to interfere with another's contract or business affairs when it does so to better its own business and without intent to harm another.[179] In *Del State* a lender's actions caused the termination of the president of a debtor corporation.[180] The court found that the lender's actions were privileged because the actions were based on its desire to better its financial position as a creditor.[181]

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173. *Farah*, 678 S.W.2d at 690.

174. 727 F.2d 1399 (6th Cir. 1984). For other cases involving lender interference, see: *In re* Red Cedar Constr. Co., 63 Bankr. 228, 242-43 (Bankr. W.D. Mich. 1986) (cause of action for interference denied because bank did not intentionally cause a breach of the plaintiff's contract, nor did the bank intend to cause the termination of the plaintiff's business relationship); Iron Mountain Sec. Storage Corp. v. American Specialty Foods, 457 F. Supp. 1158, 1170 (E.D. Pa. 1978) (defendant's counterclaim of wrongful publication of its indebtedness to tbe plaintiff was insufficient to state a claim for interference); and *Kruse*, 202 Cal. App. 3d at 65-66, 248 Cal. Rptr. at 234 (lender's failure to provide long term financing did not constitute interference because the interference must be by a third party, not by a party to the economic relationship with which interference is claimed).

175. *Melamed*, 727 F.2d at 1403-04.

176. *Id.* at 1404.

177. *Id.* at 1403-04. Note the similarity of the facts in this case with those cases described under tbe section on fiduciary duty based on control. *See supra* notes 64-103 and accompanying text.

178. 548 P.2d 1024 (Okla. 1976).

179. *Id.* at 1027.

180. *Id.* at 1025.

181. *Id.* at 1027.

4. Negligence

A valid claim for negligence arises from injury proximately caused by the failure of one owing a duty to another to exercise the care that a reasonable person would exercise under similar circumstances.[182] In *First Federal Savings & Loan Association v. Caudle*[183] a lender was held liable for failing to process a loan application with due care, which resulted in the lender negligently telling the plaintiffs that they had been approved for an FHA loan when in fact that was not the case.[184] The plaintiffs did not learn of their failure to secure FHA financing until after they completed the construction of their home and thus were forced to obtain another loan at a higher interest rate.[185] The Alabama Supreme Court held that the bank had no duty to help the plaintiffs procure an FHA loan, but that once the bank undertook to assist the plaintiffs, it was required to act with due care.[186]

5. Prima Facie Tort

Under the prima facie tort theory, it is unlawful for someone intentionally to injure another by performing an otherwise lawful act if the act is done without justification.[187] While plaintiffs recently have not met with much success asserting this theory against banks, it is evident that the theory is becoming more prevalent.[188] For example, in *Centerre Bank v. Distributors, Inc.*[189] a Missouri appellate court held a lender liable under the prima facie tort theory for wrongfully calling a secured demand note in the amount of nine hundred thousand dollars. The lender had notified the debtor that the debt would be called after a period of sixty days.[190] The lender, however, continued to advance

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182. *See generally* W. PROSSER, *supra* note 22, § 110.

183. 425 So. 2d 1050 (Ala. 1982).

184. *Id.*

185. *Id.* at 1051.

186. *Id.* at 1052; *see also* Jacques v. First Nat'l Bank, 307 Md. 527, 515 A.2d 756 (1986) (holding that a bank owes its customer a duty of reasonable care in processing a loan application).

187. *See* Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517, 543 (Mo. Ct. App. 1986) (citing State v. Kansas City Firefighters Local 42, 672 S.W.2d 99, 115 (Mo. Ct. App. 1984)); *see* also Note, *The Prima Facie Tort Doctrine: Acknowledging the Need for Judicial Scrutiny of Malice*, 63 B.U.L. REV. 1101 (1981); Note, *Prima Facie Tort Recognized in Missouri*, 47 Mo. L. REV. 553, 555-60 (1983); Note, *The Prima Facie Tort Doctrine in Missouri: Commission of a Lawful Act with Intent to Injure May Result in Liability*, 50 U. Mo. K.C.L. REV. 128, 129-38 (1981); Annotation, PRIMA FACIE TORT, 16 A.L.R.3d 1191, 1201-31 (1967 & Supp. 1988). *See generally* RESTATEMENT OF TORTS, *supra* note 152, § 870 & comments.

188. Some believe that the prima facie tort theory is indistinguishable in application from the actionable implied duty of good faith and fair dealing, which sounds in contract. Ebke & Griffin, *supra* note 1, at 799. For a discussion of the implied duty of good faith and fair dealing, see *infra* notes 199-237 and accompanying text.

189. 705 S.W.2d 42 (Mo. Ct. App. 1985).

190. *Id.* at 45.

funds and to cooperate with the debtor well after the sixty day period had elapsed.[191] Suddenly, the lender made a formal demand for the note and two weeks later took possession of the debtor's assets and accounts receivable.[192] The jury found that the lender's actions were intended to injure the debtor and returned a verdict of over 7.5 million dollars, consisting of approximately 1.5 million dollars in actual damages and 6 million dollars in punitive damages.[193] The appellate court reversed the trial court on the grounds that the lender had a valid business reason to justify its actions,[194] but acknowledged that a claim for prima facie tort was a valid cause of action.[195]

Another Missouri appellate court also failed to find the requisite elements for prima facie tort in *Shaughnessy v. Mark Twain State Bank*.[196] The *Shaughnessy* court found that the defendant-bank lacked the necessary intent to cause injury.[197] The court noted that the lender's awareness that injury might be the natural and probable consequence of its actions did not constitute the type of intent required under prima facie tort.[198]

Unlike the traditional tort theories applied in *Farah*, the prima facie tort lacks predictability. Banks will find it difficult to evaluate their risks until precedential guidelines are established. Until such guidelines are available, banks may retreat from their roles as monitors and senior creditors, thus leaving failing debtors and junior creditors to fend for themselves.

C. Duty of Good Faith—Tort or Contract?

Breach of the duty of good faith is becoming one of the claims most frequently asserted against lenders. Courts differ, however, on the type of damages that can be recovered. Some courts have allowed only contractual remedies, citing the Uniform Commercial Code (U.C.C.), the *Restatement (Second) of Contracts* (*Restatement*), or common law.[199]

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191. *Id.* at 46.

192. *Id.*

193. *Id.* at 44. The trial court reduced the jury award to three million dollars. *Id.*

194. *Id.* at 55.

195. *Id.*

196. 715 S.W.2d 944 (Mo. Ct. App. 1986).

197. *Id.* at 949.

198. *Id.*; *see also Rigby*, 713 S.W.2d 517 (upholding a summary judgment against a claim for prima facie tort when a defendant-bank was justified in calling the plaintiff's note).

199. *See, e.g.*, Iron Mountain Sec. Storage Corp. v. American Specialty Foods, 457 F. Supp. 1158 (E.D. Pa. 1978); Carrico v. Delp, 141 Ill. App. 3d 684, 490 N.E.2d 972 (1986); *Rigby*, 713 S.W.2d 517; Rodgers v. Tecumseh Bank, 756 P.2d 1223 (Okla. 1988). For a detailed discussion of tbe breach of the duty of good faith, see generally Special Project Note, *"Bad Faith Breach"*, *infra*.

Other courts also have allowed recovery in tort.[200] Even among the jurisdictions agreeing on the type of remedies allowed for a breach of the duty of good faith, there is disagreement on *when* the duty of good faith can be imposed.[201]

Amidst this lack of judicial uniformity, the U.C.C. defines good faith as "honesty in fact in the conduct or transaction concerned,"[202] and U.C.C. section 1-203 states that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[203] The *Restatement* includes virtually the same edict.[204] Thus, the duty of good faith requires cooperation so that all parties in a transaction will achieve their respective, reasonable expectations.[205] The following cases illustrate the substantial liability lenders can face for breaching the duty of good faith.

1. Line of Credit Cases

Some of the more far reaching lender liability cases have been based on a lending procedure that establishes a line of credit. A line of credit is essentially a pre-approval procedure effected for the convenience of both lender and borrower. A borrower with a line of credit is approved to borrow up to a predetermined limit without going through a complete loan application process each time.[206] Traditionally, a lender has not been obligated to fund the borrower up to the predetermined limit unless the line of credit agreement specifically provided for full funding.[207] Thus, under the traditional theory, a lender could terminate the agreement at will.

In *K.M.C. Co. v. Irving Trust Co.*[208] the Sixth Circuit confronted

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200. *See, e.g.*, Noonan v. First Bank Butte, 740 P.2d 631 (Mont. 1987); First Nat'l Bank v. Twombly, 213 Mont. 66, 689 P.2d 1226 (1984).

201. *See infra* notes 206-37 and accompanying text.

202. U.C.C. § 1-201(19) (1987). The *Restatement (Second) of Contracts* elaborates further by giving examples of actions which violate good faith: "[E]vasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance." RESTATEMENT OF CONTRACTS, *supra* note 63, § 205 comment d.

203. U.C.C. § 1-203 (1987).

204. *See* RESTATEMENT OF CONTRACTS, *supra* note 63, § 205 (stating that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement").

205. Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 669 (1963).

206. *See* BLACK'S, *supra* note 104, at 837.

207. *See, e.g.*, Midlantic Nat'l Bank v. Commonwealth Gen. Ltd., 386 So. 2d 31, 33 (Fla. Dist. Ct. App. 1980) (holding "[a line of credit] does not impart upon the bank the legal responsibility to loan up to the limit").

208. 757 F.2d 752 (6th Cir. 1985); *see also* Special Project Note, *"Bad Faith Breach", infra*, at notes 99-108 and accompanying text; Special Project Note, *Written Agreements, infra*, at note

this traditional rule when a jury awarded the borrower 7.5 million dollars in damages as a result of the lender's bad faith refusal to continue to fund the borrower under a line of credit. The borrower's line of credit agreement required deposit of all of its accounts receivable into a "blocked account" to be credited against the outstanding loan balance.[209] This arrangement left K.M.C. totally dependent on the lender for operating capital.[210] Three years into the lending arrangement, the lender suddenly refused a routine advance to K.M.C., although the loan balance would not have exceeded the 3.5 million dollar lending limit.[211] With no other funds available, K.M.C. soon collapsed.[212]

The *K.M.C. Co.* court, relying on the U.C.C.,[213] held that the duty of good faith required the lender to notify the borrower of its refusal to lend in order to allow the borrower an opportunity to obtain alternate financing or a buyer.[214] The lender could have avoided liability if it had shown a valid business reason for its actions.[215] At the time of the refusal, however, the lender was fully secured and would have suffered no loss in the event of liquidation.[216] Additionally, the jury made no finding that a notice period would have decreased K.M.C.'s ability to pay back the loan.[217]

Despite the apparent expansion of liability under *K.M.C. Co.*, several courts addressing the duty of good faith issue have chosen to distinguish *K.M.C. Co.* from the line of credit claims brought before them. For example, in *Shaughnessy v. Mark Twain State Bank*[218] a lender refused to advance funds under a line of credit although the borrower previously had notified the lender of his continued need for the funds.[219] The Missouri appellate court distinguished the situation from *K.M.C. Co.*, finding that Shaughnessy could have obtained alternate funding more easily than the borrower in *K.M.C. Co.*[220] Because the

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104 and accompanying text.

209. *K.M.C. Co.*, 757 F.2d at 759.

210. *Id.*

211. *Id.* at 754, 762-63. Evidence at trial suggested that the refusal may have been motivated, at least in part, by a personality conflict between the loan officer and the borrower. *Id.* at 761.

212. *Id.* at 754.

213. The court cited comment 8 to U.C.C. § 2-309, which states that "'the application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute arrangement.'" *Id.* at 759 (quoting U.C.C. § 2-309 official comment 8 (1987)).

214. *Id.* at 763.

215. *Id.*

216. *Id.* at 762.

217. *Id.*

218. 715 S.W.2d 944 (Mo. Ct. App. 1986).

219. *Id.* at 946.

220. *Id.* at 953.

lender did not have as much control over Shaughnessy's capital as the lender in *K.M.C. Co.*, the *Shaughnessy* court did not find that the lender's failure to give notice of termination constituted bad faith.[221]

Two recent cases, however, arguably show support for *K.M.C. Co.*, although in one case the court did not reach a decision on the issue of a duty of good faith, and in the other extraneous factors were involved. An Illinois appellate court acknowledged in *Carrico v. Delp*[222] that there is a requirement of good faith when a lender terminates a line of credit agreement, but did not reach this issue. In *Reid v. Key Bank*[223] the jury found that the lender had terminated the borrower's credit in bad faith. The finding, however, was based partially on grounds of improper racial motivation.[224] Thus, *K.M.C. Co.* did not receive strong judicial support from either decision.

2. Demand Note Cases

The demand note cases have developed around the official comment to U.C.C. section 1-208. Section 1-208 requires a party to exercise good faith when making a decision to accelerate payment or to require additional collateral.[225] The official comment to section 1-208 specifically excepts demand obligations "whose very nature permits call at any time with or without reason."[226] Because the "without reason" language arguably could justify a bad faith demand, several courts have refused to require good faith when a demand note is involved.

In *Centerre Bank v. Distributors, Inc.*[227] a borrower unsuccessfully claimed bad faith when the lender exercised its option to call a demand note. *Centerre* involved a borrower who recently purchased a highly leveraged business[228] and financed the transaction by a demand note from the bank. When the borrower asked about continued financing by the bank, a loan officer informed him that there would be no difficulty.[229] Despite these representations, the bank notified the borrower of its intention to call the note three days after the borrower's purchase

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221. *Id.* The court in Flagship National Bank v. Gray Distribution Systems, 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986), also distinguished the *K.M.C. Co.* decision. In *Flagship* the borrower had exceeded his credit limit, had a shorter course of dealing with the lender, and arguably had been given some form of notice. *Flagship*, 485 So.2d at 1341.

222. 141 Ill. App. 3d 684, 490 N.E.2d 972 (1986).

223. 821 F.2d 9 (1st Cir. 1987).

224. *Id.* at 11-12.

225. U.C.C. § 1-208 (1987); *see* Brown v. Avemco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979).

226. U.C.C. § 1-208 official comment (1987).

227. 705 S.W.2d 42 (Mo. Ct. App. 1986).

228. *Id.* at 45.

229. *Id.*

of the business.[230] A Missouri court of appeals dismissed the borrower's claim of bad faith stating that a requirement of good faith would add an additional term to which the parties did not agree.[231] Similarly, a Florida appellate court, in *Flagship National Bank v. Gray Distribution Systems*,[232] was faced with a claim of bad faith in calling a demand note and held that an obligation of good faith could not be imposed to override the express terms in the contract allowing the note to be called on demand.[233]

Some courts, however, have chosen to require good faith despite the presence of demand language in a note. The line of credit extended to the borrower in *K.M.C. Co.* was subject to payment on demand.[234] The *K.M.C. Co.* court, apparently oblivious to section 1-208's comment, stated that "[t]he demand provision is a kind of acceleration clause, upon which the Uniform Commercial Code and the courts have imposed limitations of reasonableness and fairness."[235] Other courts similarly have chosen to ignore demand language in a note,[236] or have found that a note improperly was characterized as a demand note.[237]

3. Tortious Breach of Good Faith

The possibility of tortious liability is even more alarming to lenders than contractual liability for breach of the duty of good faith. This cause of action has become prevalent in insurance cases in which tort remedies are provided for breach of the implied covenant of good faith and fair dealing.[238] An attempt to extend these insurance principles to other commercial settings was made in *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*[239] Before *Seaman's*, tort remedies generally were not available for the breach of a commercial contract.

The California Supreme Court recognized in *Seaman's* that relationships outside the insurance area could give rise to a tortious cause of action, but refused to extend tort remedies to all commercial con-

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230. *Id.*

231. *Id.* at 48.

232. 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986).

233. *Id.*

234. *K.M.C. Co.*, 757 F.2d at 760.

235. *Id.*

236. *See, e.g.*, Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. Ct. App. 1986).

237. *See, e.g.*, Reid v. Key Bank, 821 F.2d 9 (1st Cir. 1987).

238. *See, e.g.*, Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979); Hoskins v. Aetna Life Ins. Co., 6 Ohio St. 3d 272, 452 N.E.2d 1315 (1983); Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165 (Tex. 1987).

239. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984). For a further discussion of *Seaman's*, see Special Project Note, *"Bad Faith Breach"*, *infra*, at notes 71-85 and accompanying text.

tracts.[240] Instead, the *Seaman's* court created a limited cause of action for tortious breach of the implied covenant of good faith when a defendant denies in bad faith that a contract exists, or when a defendant adopts a "stonewall" position.[241] Although claims of bad faith denial and stonewalling have not yet become prevalent against lenders, *Seaman's* may have opened the door.

To date, only one reported case imposes tort liability on a lender for bad faith.[242] In *First National Bank v. Twombly*[243] the borrower signed a promissory note that required a lump sum payment in the middle of August.[244] When the borrower began to have financial difficulties prior to August, he arranged with his loan officer to have the note converted into an installment note.[245] The loan officer was scheduled to be out of town on the date set to convert the loan, but he assured the borrower that he had arranged for the lender's vice president to handle the conversion.[246] The vice president, however, claimed to know nothing about the conversion and, instead, insisted that the borrower pay the full amount of the promissory note immediately.[247] Although the note was not due for another two weeks, the vice president decided to offset the loan balance against the borrower's checking account.[248] The Montana Supreme Court in *Twombly* held that the duty to exercise good faith could be "imposed by law," as well as by the contract itself.[249] Although the court acknowledged that only contractual damages could be recovered for a breach of the duty of good faith under the U.C.C., it stated that punitive damages could be awarded for a breach of the duty of good faith imposed by law.[250] The court held that the lender had breached the duty imposed by law by acting in reckless disregard of the borrower's rights, and that such actions supported a

240. *Seaman's*, 36 Cal. 3d at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

241. *Id.* "Stonewalling" occurs when the defendant adopts a "see you in court" attitude without cause and with no belief that he has a reasonable defense. *Id.* at 769-70, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

242. First Nat'l Bank v. Twombly, 213 Mont. 66, 689 P.2d 1226 (1984). A Montana case, Noonan v. First Bank Butte, 740 P.2d 631 (Mont. 1987), acknowledged that tortious breach of the covenant of good faith and fair dealing may exist in a lending situation. The court in Rodgers v. Tecumseh Bank, 756 P.2d 1223 (Okla. 1988), also conceded that tortious breach of contract might lie in certain circumstances. *Id.* at 1227.

243. 213 Mont. 66, 689 P.2d 1226 (1984). For a further discussion of *Twombly*, see Special Project Note, *"Bad Faith Breach," infra*, at notes 110-25 and accompanying text.

244. *Twombly*, 213 Mont. at 68, 689 P.2d at 1228.

245. *Id.* at 69, 689 P.2d at 1228.

246. *Id.*

247. *Id.*

248. *Id.* at 70, 689 P.2d at 1229.

249. *Id.* at 73, 689 P.2d at 1230.

250. *Id.*

jury award of punitive damages.[251]

No other court has imposed tortious liability on a lender for breach of the duty of good faith, but several courts have expressed a willingness to do so in appropriate circumstances. The Montana Supreme Court, in *Noonan v. First Bank Butte*,[252] acknowledged that tortious breach of the covenant of good faith and fair dealing would be found when a defendant acted in a manner that was "arbitrary, capricious or unreasonable, and exceeded plaintiffs' justifiable expectation."[253] The Oklahoma Supreme Court refused to impose tortious liability on a lender for breaching a loan agreement in *Rodgers v. Tecumseh Bank*,[254] but recognized that "[g]ross recklessness or wanton negligence on behalf of a party to a contract may call for an application of the theory of tortious breach of contract."[255] Thus, although courts are hesitant to impose tortious liability on a lender in a commercial setting, tortious breach of the covenant of good faith and fair dealing is a valid cause of action in several jurisdictions.[256]

IV. Effects of Lender Liability

The previously discussed cases demonstrate the lack of guidelines available for most of the lender liability theories being applied today. Because lender liability is still a relatively new phenomenon, cases with similar facts often will result in drastically different holdings.[257] In some instances courts view lenders as occupying a special position of responsibility and power in society, while in others lenders are seen as merely business entities to be treated like any other business entity. In reality, it is the circumstances of each different situation that are determinative of a lender's role in any given transaction.[258] The theories of liability

251. *Id.*

252. 740 P.2d 631 (Mont. 1987).

253. *Id.* at 635 (citing McGregor v. Mommer, 714 P.2d 536, 546 (Mont. 1986)). The court made this statement in the context of evaluating jury instructions. The jury had been given an instruction for breach of good faith under the U.C.C. The court held that finding a breach under this instruction was not enough to constitute a tort, then went on to give the requirements for tortious breach of the covenant of good faith. *Id.* at 634-35.

254. 756 P.2d 1223 (Okla. 1988).

255. *Id.* at 1227.

256. Some courts, however, have held that tortious liability is not appropriate in commercial settings. *See, e.g.*, Iron Mountain Sec. Storage Corp. v. American Specialty Foods, 457 F. Supp. 1158, 1169 (E.D. Pa. 1978) (holding that Pennsylvania law would not allow tort recovery for breach of the implied contractual duty of good faith and fair dealing in an ordinary commercial setting); Carrico v. Delp, 141 Ill. App. 3d 684, 690, 490 N.E.2d 972, 977 (1986) (stating that "[w]hile the law does not condone breach of contract, it does not consider it wrongful or tortious").

257. *Compare* A. Gay Jenson Farms Co. v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981) *with* Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973).

258. *See supra* notes 64-134 and accompanying text.

discussed above have not been applied enough in a lender context to provide parameters that would form a basis for more consistent holdings.

One result of the uncertainty in the area of lender liability is higher transaction costs to borrowers and other bank customers. Because it is now much more difficult for banks to evaluate their risks when entering into a relationship with a customer or borrower, the costs of evaluation have increased.[259] Banks then pass these increased costs on to borrowers and customers in the form of higher loan processing fees and elevated service charges. In some instances[260] banks are unable to pass on the increased costs and must absorb the expenses internally.[261]

Another result of the uncertainty caused by inconsistent decisions is the deterrent effect on banks that engage in monitoring troubled debtors. As senior creditors, banks monitor debtors in order to classify the repayment potential of outstanding obligations. In the process of protecting their own interests, banks often provide sophisticated financial advice that the debtor otherwise would be unable to obtain.[262] Additionally, by monitoring a highly leveraged debtor, the senior creditor relieves more junior creditors from their monitoring duties,[263] and thus reduces the other creditors' costs by allowing them to "free-ride" on the senior creditor's monitoring activities.[264] Thus, monitoring benefits the debtor and junior creditors and, at the same time, provides protection for the monitor.

Lender liability problems begin to arise when a lender acting as the senior creditor steps in to try to salvage a failing debtor.[265] If the lender is successful, the debtor is saved and no one complains. If the lender is unsuccessful, however, junior creditors and the debtor frequently have viewed the lender as a deep pocket against whom to recover losses. Monitoring lenders attempting to save a troubled debtor increasingly

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259. Lending transactions encompass a variety of risks that cannot all be anticipated. The possibility of lender liability increases the difficulty of assessing credit risks. This results in a more lengthy and costly evaluation process. Increased certainty in the area of lender liability would enable lenders to evaluate their risks more efficiently.

260. For example, when a post-disbursement event causes an already existing loan to be reevaluated, the bank has no way to pass the costs of evaluation on to the borrower.

261. In these times of frequent bank failures, additional expenses such as these can be difficult, if not impossible, for a bank to absorb successfully.

262. *See* Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 931 (1986).

263. *Id.*

264. *Id.* at 931-32; *see also* Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 53-54 (1982).

265. Often, the senior creditor is encouraged to become involved to give financial advice to the debtor and to monitor the situation, which provides protection for all of the creditors. Scott, *supra* note 262, at 919-22.

have been found liable under one of the control theories.[266] As a result, lenders are discouraged from aiding troubled borrowers and from providing beneficial monitoring services. In order to decrease the risks of liability in monitoring and avoid this chilling effect, courts must distinguish clearly between a lender legitimately protecting its interests and a lender overreaching its authority as a monitor. Clear guidelines are needed in this area to encourage lenders to continue their activities as monitors.

V. JUDICIARY'S RESPONSE

The early decisions in the area of lender liability can best be viewed as a series of emergency measures,[267] not as a comprehensive and consistent body of law. Most of the decisions were made in relative isolation as cases of first impression. Thus, the liability theories existing today are not the result of a carefully planned master program.[268] Several recent reversals, however, show that appellate courts are beginning to require clearly proven elements before a lower court's decision against the lender will be upheld.[269] Some courts also have begun to recognize that borrowers owe lenders some of the same duties of openness and fair dealing that have been required of lenders.[270]

A prominent example of a reversal based on a plaintiff's failure to prove his cause of action clearly is *Kruse v. Bank of America*.[271] A California appellate court reversed an award of twenty-six million dollars[272] in what was deemed to be one of California's first big "farm cases."[273] After a detailed review of the facts, the *Kruse* court held that the jury verdicts for fraud, bad faith denial of contract, emotional distress, and intentional interference with prospective business advantage were legally insupportable.[274] The court essentially separated each claim into its respective required elements and, for each claim, found that one or more of the elements could not be met by the facts of the case.[275] *Kruse*'s articulate evaluation goes a long way in educating lenders about

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266. *See supra* notes 64-103 and accompanying text.

267. *See* Ebke & Griffin, *supra* note 1, at 813.

268. *Id.*

269. *See, e.g.*, Pentbouse Int'l, Ltd. v. Dominion Fed. Sav. & Loan Ass'n, 855 F.2d 963 (2d Cir. 1988); Kruse v. Bank of Am., 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988).

270. *See, e.g.*, FDIC v. W.R. Grace & Co., 691 F. Supp. 87 (N.D. Ill. 1988) (discussed in 1 LENDER LIABILITY LAW, *supra* note 16, No. 12, at 1; Teacbers Ins. & Annuity Ass'n v. Butler, 626 F. Supp. 1229 (S.D.N.Y. 1986).

271. 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988). For a furtber discussion of *Kruse*, see Special Project note, *"Bad Faith Breach"*, *infra*, at notes 160-82 and accompanying text.

272. *Id.* at 44, 248 Cal. Rptr. at 219.

273. Butler, *Is Lender Liability Now Absolute Liability?*, 15 W. ST. U.L. REV. 595, 609 (1988).

274. *Kruse*, 202 Cal. App. 3d at 53, 62, 248 Cal. Rptr. at 225, 232.

275. *Id.* at 54-58, 60-61, 65, 67, 248 Cal. Rptr. at 226-28, 230, 233-34, 235.

exactly what will and will not expose them to liability, thereby allowing lenders to evaluate their risks more easily. This type of analysis is accomplished more readily when traditional tort claims are involved because tort elements tend to be well-established.[276] As the next case shows, the same would hold true for contractual claims.

Penthouse International v. Dominion Federal Savings & Loan,[277] with an award of one hundred twenty-nine million dollars compensatory damages, involved one of the ten highest judgments entered in 1987.[278] On appeal,[279] a New York appellate court suppored its reversal for claims of anticipatory breach and fraud with a detailed analysis of the facts. The court discussed each of the four factual bases for the claim of anticipatory breach and determined that they were not sufficient to support the district court's finding that the lender had committed an anticipatory breach.[280] The court also found that the plaintiff had not established its readiness and ability to perform—a prerequisite to a plaintiff's right to damages in an action for anticipatory breach.[281] In reviewing the district court's finding of fraud, the Second Circuit found that not all of the elements of fraud had been proven.[282] As in *Kruse*, lenders were again given a clear explanation for each of the *Penthouse* court's findings.

These cases may signify the beginning of the development of reliable guidelines in the area of lender liability. Both the *Kruse* and *Penthouse* reversals indicate that courts have begun to scrutinize claims of lender liability to ensure that each element of the claim has been proven clearly. In another step toward the development of a consistent body of law in the lender area, courts also have begun to hold borrowers to the same duties of fairness that they have imposed on lenders.

In *Teachers Insurance & Annuity Association of America v. Butler*[283] a borrower was held liable for breaching its duty to bargain in good faith. The borrower in that case had signed a commitment letter obligating it to borrow twenty million dollars.[284] Shortly after the letter was signed, however, interest rates began a decline that continued up until the closing date of the loan.[285] The borrower took advantage of the delay between the signing of the commitment letter and the closing by

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276. *See* Ebke & Griffin, *supra* note 1, at 795.
277. 665 F. Supp. 301 (S.D.N.Y. 1987).
278. 2 LENDER LIABILITY REPORT, *supra* note 16, at 2 (citing *Inside Litigation*).
279. *Penthouse*, 855 F.2d 963.
280. *Id.* at 977.
281. *Id.* at 979.
282. *Id.* at 986.
283. 626 F. Supp. 1229 (S.D.N.Y. 1986).
284. *Id.* at 1232.
285. *Id.*

seeking a more favorable loan package from other lenders.[286] The borrower then attempted to frustrate attempts to close the loan by refusing to negotiate.[287] The *Butler* court held that the borrower breached its implied duty to negotiate in good faith and awarded the lender approximately three million dollars.[288]

In another case ranking among the top ten highest judgments of 1987, a lender received one hundred million dollars in damages.[289] The jury in *FDIC v. W.R. Grace Co.*[290] found that the borrower failed to disclose material facts to the lender regarding the borrower's ability to repay its obligation.[291] Although the lender's claim in *FDIC* was not brought in response to a claim of lender liability by the borrower, it would not be surprising to see lenders using similar claims against plaintiff-borrowers in future lender liability suits.[292] This type of lender-borrower equality may curb the current flood of lender liability litigation. The introduction of "borrower liability" adds consistency and balance to the development of an effective body of lending law.

VI. Conclusion

As in any new area of legal development, the formulation of standards and guidelines in the area of lender liability will take time. The recent reversals and "borrower liability" cases demonstrate the judiciary's willingness to inject clarity and equality into the hastily developed law that resulted from the early lender liability cases. Improvement will be slow,[293] and, meanwhile, the impact that the increasing number of claims against lenders has on the credit market as a whole is significant. Escalating commercial transaction costs may have at their root lenders' fears of large, unanticipated liability. Monitoring by lenders, which provides important benefits to society as a whole, also may decrease as a result of lenders' inabilities to gauge the risks involved. Although lender liability may be needed in some circumstances to prevent lender overreaching, it is the borrower who will pay in the long run[294] as lenders

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286. *Id.*

287. *Id.* at 1235.

288. *Id.* at 1236.

289. F.D.I.C. v. W.R. Grace Co., 691 F. Supp. 87 (N.D. Ill. 1988). In a jury award, the lender received $25 million in compensatory and $75 million in punitive damages. 2 Lender Liability Law, *supra* note 16, No. 2, at 3.

290. 691 F. Supp. 87 (N.D. Ill. 1987).

291. 1 Lender Liability Report, *supra* note 16, June 1988, at 1.

292. *Id.* at 4.

293. Arbitration may be a viable alternative which could help lenders avoid the expense and delay of a judicial proceeding. *See generally* Special Project Note, *Arbitration, infra.*

294. The increased cost of evaluating lending risks and implementing safeguards will undoubtedly be passed on to the borrower as higher transactions costs.

take actions to protect themselves from claims that are often difficult, if not impossible, to anticipate.

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