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Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?

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RECENT DEVELOPMENT

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I. INTRODUCTION

The recent willingness of many courts and juries to impose liability on financial institutions[1] has prompted an increasing number of customers to bring suits against their banks and creditors. These suits often involve claims for millions of dollars in both compensatory and punitive damages for alleged bank or creditor misconduct. For example, the Sixth Circuit recently affirmed a jury award of seven and one half million dollars to a borrower whose lender suddenly refused to advance funds under a line of credit agreement.[2] In similar cases involving a bank's refusal to lend money under credit agreements, a California jury awarded approximately twenty-two million dollars in actual and punitive damages to an aggrieved borrower[3] and a Maine jury awarded fifteen million dollars in compensatory damages to a borrower.[4]

One reason for the increasing number of awards in suits against financial institutions is the expansion of bases for liability in situations involving banks and creditors. Both the Uniform Commercial Code (UCC *or* Code) and extensive federal banking

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1. For the purposes of this Recent Development, the term "financial institution" will refer to banks as well as to other types of creditors and lenders.

2. K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985). For a discussion of *Irving Trust*, see *infra* notes 114-25 and accompanying text.

3. Jewell v. Bank of Am., No. 112439 (Sonoma County Cal. Super. Ct. 1985) (appeal pending), involved a California apple grower who sued Bank of America when the bank refused to lend funds in accordance with representations made to the borrower. The jury originally returned a $37 million verdict against the bank, later reduced to $17 million actual damages and $5 million punitive damages. *See* Sudo, *Court Upholds $22 Million Damages Against Bank of America in Farm Case*, Am. Banker, Oct. 28, 1985, at 1, 23.

4. Ricci v. Key Bancshares of Me., Inc., No. 82-249P (D. Me. Apr. 13, 1987) (jury trial); *see also* Ricci v. Key Bancshares of Me., Inc., No. 82-249P, slip. op. (D. Me. Apr. 27, 1987) (considering post-judgment motions and discussing various issues addressed in trial court); Halvorsen, *Cutoff of Credit Costly to Maine Bank*, Nat'l L.J., May 4, 1978, at 3, col. 1 (detailing history of the case). Additionally, in Robinson v. Texas Commerce Bank, No. C-1948-84 (Hildago County Tex. Dist. Ct. 1987), the jury returned a $59.2 million award against a bank that refused to release a lien on a borrower's property, despite the bank's knowledge that its lien was invalid. The borrower subsequently declared bankruptcy. The jury award included $50 million for the borrower's mental anguish.

regulations provide specific forms of redress for borrowers, debtors, and bank customers.[5] In addition, traditional legal theories such as breach of contract,[6] fraud,[7] and duress[8] are available in actions against financial institutions. The new generation of suits against banks and creditors combine reliance on traditional legal theories with allegations based on innovative or "emerging" theories of liability.[9] The plaintiffs in a recent case, for example, not only charged their bank with fraud, but also claimed damages for breach of fiduciary obligation and excessive interference with the business of the debtor.[10]

Of the emerging theories of lender or creditor liability, claims for breach of the implied covenant of good faith and fair dealing

5. Article 4 of the UCC, entitled "Bank Deposits and Collections," essentially defines the rights and liabilities of banks and bank depositors. For example, § 4-207 outlines a depositor's cause of action against a bank for breach of transfer and presentment warranties. Article 9 of the UCC deals with secured transactions. Federal banking regulations are primarily contained in 12 U.S.C. §§ 1-3805 (1982), entitled "Banks and Banking."

6. The bank-customer relationship is characterized as contractual. *See infra* note 108 and accompanying text.

7. *See, e.g.*, Stirling v. Chemical Bank, 382 F. Supp. 1146, 1153 (S.D.N.Y. 1974) (holding that misrepresentations made by bank concerning loans constituted common law fraud), *aff'd*, 516 F.2d 1396 (2d Cir. 1975); Sanchez-Corea v. Bank of Am., 38 Cal. 3d 892, 909, 701 P.2d 826, 838, 215 Cal. Rptr. 679, 691 (1985) (allowing an award for punitive damages against bank tbat fraudulently induced debtor to assign all accounts receivable in return for loan); *see also* Heiman & Thomas, *Impact of Common Law Theories on Lender Recovery and Liability*, in 1 EMERGING THEORIES OF LENDER LIABILITY 17-18 (H. Chaitman ed. 1985).

8. *See, e.g.*, Pecos Constr. Co. v. Mortgage Inv. Co. of El Paso, 80 N.M. 680, 682-83, 459 P.2d 842, 844-45 (1969) (recognizing cause of action for common law duress when lender refused on date of closing to advance funds unless borrower paid additional sums); *cf.* Continental Ill. Nat'l Bank & Trust Co. v. Stanley, 606 F. Supp. 558, 562 (N.D. Ill. 1985) (rejecting claim of duress where bank insisted that borrower sign a guaranty for loan because no imminent barm posed by bank's conduct); Spillers v. Five Points Guar. Bank, 335 So. 2d 851, 852-53 (Fla. Dist. Ct. App. 1976) (recognizing cause of action for duress when party threatens to enforce nonexistent legal rights, but not when party seeks to exert legally enforceable rights); First Tex. Sav. Ass'n v. Dicker Center, Inc., 631 S.W.2d 179, 185-86 (Tex. Ct. App. 1982) (holding that conduct of bank, not financial difficulties of borrower, will determine exertion of duress). *See generally* Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775, 786-88 (1986); Heiman & Thomas, *supra* note 7, at 18-20.

9. Several authors refer to "emerging" theories of lender liability. *See, e.g.*, Ebke & Griffin, *supra* note 8, at 800-17; Burke, Thomas & Warren, *Emerging Theories of Bank Liability*, in 462 BANKS AND THEIR BORROWERS: NEW OPPORTUNITIES IN FINANCIAL SERVICES 403 (P.L.I. 1984); 1-3 EMERGING THEORIES OF LENDER LIABILITY (H. Chaitman ed. 1985).

10. *See* State Nat'l Bank of El Paso v. Farah Mfg. Co., Inc., 678 S.W.2d 661 (Tex. Ct. App. 1984). In *Farah*, the debtors charged the bank with fraud, duress, breach of fiduciary duty, and excessive interference with the business of the borrower. The court held the bank liable on tbe combined bases of fraud, duress, and interference. *Id.* For a detailed discussion of the *Farah* case see Ebke & Griffin, *supra* note 8, at 777-82. *See also* Heiman & Thomas, *supra* note 7, at 20-25 (discussing elements of "interference").

present the broadest foundation upon which to extend the liability of financial institutions. The concept of implying a covenant of good faith and fair dealing in all contracts derives from statutory as well as common law sources.[11] The inherent ambiguity of a covenant of good faith and fair dealing in bank-customer and creditor-debtor situations, however, has prompted some commentators to call the doctrine a "loose cannon" and "interpretive tool" available to "courts to further their views of justice."[12]

Recent cases demonstrate acceptance by courts and juries of the concept of good faith and fair dealing in a variety of suits against financial institutions. Some courts have expanded their interpretation of the UCC requirements of good faith and fair dealing, particularly with respect to acceleration of debts. As an alternative to extending liability under the UCC, many courts now allow an action in tort for breach of an obligation of good faith and fair dealing imposed by law on the bank-customer and debtor-creditor relationships. This newly created tort is significant because it subjects the deep pockets of financial institutions to possible punitive damage awards.

This Recent Development explores the judicial application of the implied covenant of good faith and fair dealing to the activities of lenders and creditors with the purpose of formulating standards by which future lender or creditor liability suits might be assessed. Part II summarizes the development, general scope, and historical application of the covenant of good faith to financial institutions. Part III examines recent cases in which courts have imposed liability on banks for the breach of an implied covenant of good faith and fair dealing. Part IV analyzes the legal and commercial implications of the approaches taken by these courts in applying the covenant of good faith and fair dealing to lender liability suits. Part V concludes that the trend toward expanding liability through covenants of good faith and fair dealing in lender and creditor liability suits will continue with courts applying the doctrine on a case-by-case basis.

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11. *See infra* notes 13, 63-64 and accompanying text.

12. Burke, Thomas & Warren, *supra* note 9, at 458; *see also* Warren, *Good Faith Under the Uniform Commercial Code*, in 1 EMERGING THEORIES OF LENDER LIABILITY 58 (H. Chaitman ed. 1985).

II. Legal Background

The concept of a covenant of good faith and fair dealing implied in every contract currently enjoys widespread acceptance as a fundamental principle of contract law.[13] Society supports an expansive definition of good faith in commercial law because the term itself evokes images of morality, honor, and fair play.[14] Although the implied covenant is recognized by both the common law and the UCC, neither source provides a comprehensive definition of the term "good faith."[15] Likewise, commentators and scholars seem unable to agree on clear guidelines for interpreting the obligation of good faith and fair dealing.[16] The inherent vagueness of this covenant results in varying applications by courts in different contexts, including contractual relations between financial institutions and their customers.

A. *The Implied Covenant of Good Faith and Fair Dealing Imposed on Financial Institutions by the UCC*

1. UCC Sections Requiring Good Faith

The UCC contains several provisions concerning good faith.[17] Section 1-203, entitled "Obligation of Good Faith," states the gen-

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13. *See, e.g.*, UCC § 1-203 (1978); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). *See generally* Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); Eisenberg, *Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem*, 54 MARQ. L. REV. 1 (1971); Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982); Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968) [hereinafter Summers, *Good Faith in General Contract Law*].

14. *See* Farnsworth, *supra* note 13, at 669.

15. UCC § 1-201(19) (1978) states that "'[g]ood faith' means honesty in fact in the conduct or transaction concerned." Comment 19 notes tbat "good faith," when used in the Code, means "at least" wbat is contained in § 1-201(19), but also recognizes that certain sections may impose additional requirements. *Id.* at comment 19. Section 205 of the *Restatement (Second) of Contracts* simply states: "Every contract imposes upon each party a duty of good faitb and fair dealing in its performance and its enforcement." RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). Comment d recognizes that a complete definition for "good faith" is not possible, but attempts to define what constitutes lack of good faith througb examination of judicial decisions. The *Restatement*'s recognition of actions demonstrating bad faith includes "evasion of the spirit of the bargain, lack of diligence and slacking off, [and] willful rendering of imperfect performance." *Id.* at comment d.

16. *See* Farnsworth, *supra* note 13, at 667-74 (discussing objective and subjective tests for determining good faith); Summers, *Good Faith in General Contract Law*, *supra* note 13, at 201-02; *see also* Eisenberg, *supra* note 13, at 3-10 (summarizing various approaches to "good faith" taken by scholars).

17. Professor Farnsworth notes that out of over 400 UCC provisions, more than 50

eral principle: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[18] More specifically, Article 1 defines good faith as "honesty in fact";[19] this standard applies to Article 4 banking transactions as well.[20] Another provision, section 1-102(3), prohibits agreements disclaiming the implied covenant of good faith and fair dealing, but allows a contract to determine reasonable standards by which the obligation of good faith will be measured.[21]

Commentators' interpretations of the UCC requirements of good faith vary greatly. Professor Farnsworth argues that the UCC imposes the obligation of good faith in two distinct categories: good faith purchase and good faith performance.[22] In contrast, good faith purchase, which includes lack of notice, generally refers to a party's state of mind in situations such as contract negotiations.[23] Good faith performance, however, focuses on "decency, fairness and reasonableness" in performance or enforcement of the contract within its terms.[24] Good faith performance requires the cooperation of a party so that the other party may "secure the expected benefits of the contract," measured against objective community standards.[25] Farnsworth defines good faith performance as the essence of the obligation of good faith imposed on every contract by the UCC.[26] In contrast, Professor Summers defines good faith as simply an "excluder" or "a phrase without general meaning . . . of its own [which] serves to exclude a wide range of heterogeneous forms of bad faith."[27]

Courts have applied the requirements of section 1-203 to impose certain obligations on banks and creditors in dealing with customers. In *Skeels v. Universal C.I.T. Credit Corp.*[28] the Third Circuit relied heavily on section 1-203 of the UCC to require a credit agency to notify its debtor prior to foreclosure. The parties had

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sections make some reference to "good faith." Farnsworth, *supra* note 13, at 667.

18. UCC § 1-203 (1978).
19. UCC § 1-201(19) (1978).
20. UCC § 4-103 comment 4 (1978).
21. UCC § 1-102(3) (1978).
22. Farnsworth, *supra* note 13, at 667-71.
23. *Id.* at 668.
24. *Id.* at 671-72.
25. *Id.* at 672; *see also* 1 R. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 1-203:3 (3d ed. 1981) (stating that "what is not regulated by the contract should be done in such a way as to show good faith in the carrying out of what is expressed").
26. Farnsworth, *supra* note 13, at 668.
27. Summers, *Good Faith in General Contract Law*, *supra* note 13, at 201.
28. 335 F.2d 846 (3d Cir. 1964).

executed an agreement under which the credit agency financed the debtor's purchase of new cars in return for a security interest in the merchandise. When the debtor experienced financial difficulties, the credit agency assured its customer that an additional loan would be forthcoming. The creditor, however, foreclosed on the security without notice. Citing section 1-203, the court stated that every contract implies a covenant of good faith and fair dealing[29] and concluded that the credit agency breached its implied obligation of good faith.[30]

Section 1-208, the UCC section dealing with options to accelerate a debt, imposes additional obligations of good faith performance on lenders. This section allows parties to a loan agreement to provide that the lender may accelerate payments or performance or require additional collateral "when he deems himself insecure."[31] However, the UCC allows the creditor to accelerate or require additional collateral "only if he in good faith believes that the prospect of payment or performance is impaired."[32]

Courts apply both objective and subjective standards to determine whether a belief of insecurity was held in good faith.[33] The creditor must show both that a reasonable person would have accelerated the debt under similar circumstances and that the creditor acted in good faith.[34] The actor's good faith depends on his actual mental state. Thus, the lack of factual basis for the creditor's belief in insecurity may be immaterial,[35] as might any negli-

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29. *Id.* at 851. The court characterized the question posed by the case as "whether the assurances given and the reasonable expectations created by [the credit agency] could make tortious the otherwise proper action of [the creditor] in foreclosing on its security without notice or opportunity to seek other financing." *Id.* at 850.

30. *Id.* (stating that "a jury could not easily avoid the conclusion that it would be grossly improper and inconsistent with good faith dealing for a secured creditor . . . to persist in assurance that he was about to make further advances . . ., and then, without notice, exercise his security rights").

31. UCC § 1-208 (1978).

32. *Id.*

33. *See, e.g.*, Sheppard Fed. Credit Union v. Palmer, 408 F.2d 1369, 1371 n.2 (5th Cir. 1969), *citing* 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 43.4, at 1197 (1965); Blaine v. G.M.A.C., 82 Misc. 2d 653, 655, 370 N.Y.S.2d 323, 327 (Monroe County Ct. 1975) (stating that "[t]he criterion for permissible acceleration under Section 1-208 . . . has the dual elements of whether: (1) a reasonable man would have accelerated the debt under the circumstances; and (2) whether the creditor acted in good faith"); *see also* K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752, 760-61 (6th Cir. 1985) (applying the *Blaine* test for good faith belief in insecurity). *See generally* Farnsworth, *supra* note 13, at 667-74 (discussing subjective and objective standards).

34. *See Sheppard*, 408 F.2d at 1371 (placing burden of proof on creditor to show reasonableness of conduct).

35. *See Blaine*, 82 Misc. 2d at 655-56, 370 N.Y.S.2d at 327.

gence in the formation of that belief.[36] Consequently, the good faith of the creditor's belief of insecurity becomes a highly subjective determination.[37] When assessing insecurity under section 1-208, courts generally require that secured, as opposed to unsecured, creditors demonstrate more facts prompting the belief of insecurity.[38]

The good faith requirements of section 1-208 appear to apply in the narrow situation in which acceleration occurs because of creditor insecurity. At least one court, however, extended the principles of good faith in section 1-208 to a different set of circumstances. In *Brown v. AVEMCO Investment Corp.*[39] the Ninth Circuit applied section 1-208 to a lender's acceleration of a debt under a promissory note containing an insecurity acceleration clause solely because of a technical breach of the parties' agreement.[40]

In assessing the lender's acceleration of the debt, the Ninth Circuit invoked section 1-203 of the UCC, holding that every contract contains an implied covenant of good faith and fair dealing. More significantly, the court found that section 1-208 applied as well. The court noted that although *AVEMCO*'s acceleration resulted from a technical default on the agreement, the clause in the agreement did not provide for automatic acceleration upon default. The *AVEMCO* court concluded that because the clause arguably allowed the creditor discretion to accelerate for any reason, the good faith requirements of section 1-208 applied to *AVEMCO*'s acceleration according to the official comment, which states that the

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36. *Id.; see also* Van Horn v. Van De Wol, Inc., 6 Wash. App. 959, 497 P.2d 252 (1972). In *Van Horn*, a stockholder made several unsecured loans to a corporation. Believing that the corporation failed to obtain a necessary bank loan, the stockholder deemed himself insecure and accelerated the debt. The court held that the unsecured creditor acted in good faith because a creditor could consider the overall financial stability of the debtor in determining prospects of payment without actually checking into the actual financial affairs. The court stated: "Anything which adversely affected the corporation adversely affected plaintiff's prospect of payment." *Id.* at 961, 497 P.2d at 254.

37. *See* 1 R. ANDERSON, *supra* note 25, § 1-208:15.

38. *See* McKay v. Farmers & Stockmens Bank of Clayton, 92 N.M. 181, 585 P.2d 325, *cert. denied*, 92 N.M. 79, 582 P.2d 1292 (1978). In *McKay*, the bank seized property serving as security for a loan after deeming itself insecure. Although the borrowers defaulted on the loan, the court found that the value of the security exceeded the outstanding balance on the note. In addition, the bank had waived previous defaults while the borrowers attempted to obtain alternate financing. On the basis of these facts, the court found the bank's good faith in seizing the security questionable. *Id.* at 183, 585 P.2d at 327.

39. 603 F.2d 1367 (9th Cir. 1979).

40. The agreement gave the lender a security interest in the borrower's airplane. The horrower technically breached the agreement by leasing the plane without consent and the lender accelerated the debt. *Id.* at 1369.

primary purpose behind section 1-208 is to control creditor abuse of discretion.[41]

Read broadly, *AVEMCO* suggests that the requirement of good faith should extend to all situations in which the creditor exercises discretion.[42] The court characterized its extension of the section 1-208 good faith requirement as consistent with the intent and purpose of the section. Many courts, however, decline to read section 1-208 broadly enough to impose a covenant of good faith on accelerations for reasons other than belief in insecurity.[43]

While courts generally find the good faith requirement of section 1-208 applicable to debts not yet due, most courts reject an extension of section 1-208 into other areas, particularly the calling of demand notes by creditors. In *Fulton National Bank v. Willis Denney Ford, Inc.*,[44] for example, the Georgia Court of Appeals held that the good faith provisions in section 1-208 are inapplicable to demand notes. The court found that demand notes, by nature, permit a call by the creditor at any time after execution and that section 1-208 applies only to notes payable at a future date.[45] The court rejected the borrower's claim that section 1-203 alone

41. *Id.* at 1378-79. The UCC comment to § 1-208 provides, in pertinent part, that the phrase "acceleration at will" does not grant the option at the "whim" or "caprice" of the creditor. "This Section is intended to make clear that despite language which can be so construed . . ., the clause means that the option is to be exercised only in . . . good faith belief. . . ." UCC § 1-208 official comment (1978).

42. *See AVEMCO*, 603 F.2d at 1378-80; *cf.* California Lettuce Growers v. Union Sugar Co., 45 Cal. 2d 474, 484, 289 P.2d 785, 791 (1955) (stating that "where a contract confers on one party a discretionary power affecting the rights of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing"). *Compare* K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752, 760 (6th Cir. 1985) (noting a parallel between discretionary acceleration and discretionary demand for payment).

43. *See, e.g.*, Gorham v. Denha, 77 Mich. App. 264, 258 N.W.2d 196 (1977); Fay v. Marina, 6 U.C.C. Rep. Serv. 516 (N.Y. Sup. Ct. 1969); Crockett v. First Fed. Sav. & Loan Ass'n, 289 N.C. 620, 630-31, 224 S.E.2d 580, 587-88 (1976). In Rigby Corp. v. Boatmen's Bank and Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986), the bank called an indebtedness on its due date and then set off the obligation against the borrower's checking account. The borrower claimed that the failure of the bank to extend its note constituted an acceleration in violation of the § 1-208 requirement of good faith. The court rejected this argument, finding that the good faith requirement of the UCC covered only the performance of the contract and that the calling of the matured debt transcended performance. *Id.* at 528. In addition, the court rejected the borrower's argument that the bank's setoff action constituted a bad faith acceleration within the meaning of § 1-208. *Id.* at 528-30. The court also considered the bank's good faith in demanding additional collateral under UCC § 1-208, but concluded that the bank made the demand pursuant to a good faith belief in Rigby's impaired ability to pay. *Id.* at 530-35.

44. 154 Ga. App. 846, 269 S.E.2d 916 (1980).

45. *Id.* at 848, 269 S.E.2d at 918, *citing* 1 R. ANDERSON, *supra* note 25, § 1-208:2 (2d ed. 1970).

imposes an obligation on the bank to act in good faith. The court acknowledged that section 1-203 requires a party to carry out in good faith necessary obligations not directly provided for in the contract, but stated that section 1-208 did not apply because the date provision in the note expressly regulated the time of payment.[46]

In 1985 the Missouri Court of Appeals reaffirmed the principles of *Fulton.* In *Centerre Bank of Kansas City v. Distributors, Inc.*[47] the guarantors of a demand note alleged breach of the implied covenant of good faith when the bank called the note due despite the bank's receipt of additional personal guaranties for the loan.[48] At trial, the jury awarded the borrowers and guarantors over seven million dollars in actual and punitive damages. In reversing the decision, the court of appeals cited UCC section 3-122 for the proposition that a cause of action against the maker of a demand note accrues on the day of execution. The court held that the good faith requirement of section 1-203 pertains only to performance of a contractual duty and that, because a call for payment fell within the bank's contractual rights, an imposition of an obligation of good faith would, in effect, add a new term to the contract.[49]

Several Florida cases also implicitly rejected the applicability of section 1-208 to a bank's discretionary termination of ongoing financing arrangements. In *Grandin Industries, Inc. v. Florida National Bank*[50] the bank and borrower executed an accounts receivable funding agreement under which the bank agreed to lend money from time to time at its own discretion. The agreement contained a clause providing for termination by written notice.[51] Because the obligation of the bank was discretionary, the court held that the bank could refuse further funds without breaching the

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46. *Id.* at 848-49, 269 S.E.2d at 918-19; *see also* Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank of Wash., 10 Wash. App. 530, 518 P.2d 734, *cert. denied*, 419 U.S. 967 (1974). In *Allied*, the borrower sued the bank-lender, alleging the bank's lack of good faith in calling due the entire indebtedness on several demand promissory notes. The court held that under UCC § 3-122 a demand provision in a note renders the debt payable on the date of execution. Thus, the bank had a right to declare the note due on the day of its choosing, without actual demand. *Id.* at 536-37, 518 P.2d at 738.

47. 705 S.W.2d 42 (Mo. Ct. App. 1985).

48. The guarantors claimed that the bank made assurances to them that the loan would be extended. *Id.* at 48.

49. The court stated that "[t]he Bank could not be required in the name of good faith to surrender its right under the demand note to call for payment at any time." *Id.*

50. 267 So. 2d 26 (Fla. Dist. Ct. App. 1972).

51. *Id.* at 27-29.

agreement. Further, the court rejected the borrower's claim that the agreement implicitly required notice of refusal to lend. The court found that only complete termination of the agreement, not refusal to lend on one occasion, would require notice and that no contractual obligation to continue lending existed.[52] The court did not discuss good faith.

Similarly, in *Midlantic National Bank v. Commonwealth General, Ltd.*[53] the Florida Court of Appeals rejected a borrower's claim that his lender improperly terminated funding under a line of credit arrangement. The borrower alleged that his business collapsed as a result of the bank's refusal to lend. Despite a jury award of both actual and punitive damages, the appellate court reversed, finding that the line of credit carried no obligation to lend up to the established limit.[54] The court found that, without any written agreement on the terms of the credit, the bank could terminate the agreement at its discretion without liability under section 1-208.[55]

2. Damages for Breach of Good Faith Under the UCC

In addition to defining the extent to which the good faith provisions apply to financial institutions, courts also must determine the measure of damages for a breach of the covenant of good faith. The UCC imposes a duty of good faith performance of a contract within its terms and provides an express remedy for breach of that duty. UCC section 1-106 states:

> The remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law.[56]

Thus, the UCC expressly limits recovery to contract damages for the breach of the covenants of good faith imposed by sections 1-203 and 1-208. Contract damages should put the aggrieved party in as good a position as if the breach had not occurred.[57] The UCC

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52. *Id.* at 30. *Compare* K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752, 759 (6th Cir. 1985) (requiring notice of refusal to lend).

53. 386 So. 2d 31 (Fla. Dist. Ct. App. 1980).

54. *Id.* at 33.

55. *Id.* The court also expressed indifference to the fact that the horrower's business collapsed as a result of the bank's refusal to lend. *Id.* at 34.

56. UCC § 1-106(1) (1978).

57. *See Rigby*, 713 S.W.2d at 536; *see also* Nobs Cbem., U.S.A., Inc. v. Koppers Co.,

generally does not allow recovery of punitive damages.[58]

Despite this explicit limitation of damages in the UCC, the Third Circuit in *Skeels v. Universal C.I.T. Credit Corp.*[59] upheld an award of punitive damages against a creditor who foreclosed on security without notice. The court discussed the reasonable expectations of the parties and inferred that the failure to provide notice or an opportunity to seek alternate financing constituted a tortious breach of the obligation of good faith imposed by section 1-203.[60] Some state court decisions, however, have rejected the *Skeels* holding by expressly denying recovery of punitive damages for breach of a commercial credit contract.[61] While these decisions conclude that breach of the section 1-203 and section 1-208 obligations of good faith give rise to only contract damages, other courts now recognize a cause of action for breach of the obligation of good faith in tort on the basis of "other law" outside the UCC.[62]

Inc., 616 F.2d 212, 215 (5th Cir. 1980). *See generally,* 1 R. ANDERSON, *supra* note 25, § 1-106:9.

58. UCC § 1-106(1) (1978). While the UCC adopts the general rule that punitive damages are not recoverable in contract, Professor Anderson notes tbat exceptions may exist. In addition, a plaintiff may recover punitive damages in contract if authorized by non-Code law. 1 R. ANDERSON, *supra* note 25, § 1-106:11. *See generally* J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 14-3, at 520 (2d ed. 1977).

59. 335 F.2d 846 (3d Cir. 1964). For a discussion of *Skeels,* see *supra* notes 28-30 and accompanying text.

60. *Id.*

61. *See, e.g., Rigby,* 713 S.W.2d 517 (Mo. Ct. App. 1986). In *Rigby,* tbe court noted that the *Skeels* decision was undermined greatly by the bolding in Iron Mountain Security Storage Corp. v. American Specialty Foods, Inc., 457 F. Supp. 1158 (E.D. Pa. 1978), which according to *Rigby,* "unequivocally [held] that Pennsylvania does not allow a tort recovery for breach of a Code contract duty of good faith in an ordinary commercial transaction." *Rigby,* 713 S.W.2d at 536 n.12.

62. *See, e.g., Rigby,* 713 S.W.2d at 537 n.13. The court stated:

> Our non-Code, *other law,* also recognizes a general obligation of good faith and fair dealing in tbe performance and enforcement of contracts and implicitly recognizes a *contract* remedy for the breach. Our non-Code law does recognize tbat where the contract places the contractors in a special relationship or status which tbe law protects, the breach of the contract obligation of good faith gives rise to an action in tort independent of the contract.

Id. (citations omitted) (emphasis in original).

B. *Applying the Common Law Implied Obligation of Good Faith and Fair Dealing to Financial Institutions*

1. Creation of the Tort of Breach of Good Faith in the Insurance Field

In addition to the covenant of good faith and fair dealing imposed on contracts within the ambit of the Uniform Commercial Code, the common laws of many states acknowledge an obligation of good faith with respect to contracts.[63] One court stated the common law principle in terms virtually identical to section 1-203: "It is not disputed that every contract carries with it an implication that the parties will act in good faith."[64] Commentators note that the UCC essentially adopts the common law rule concerning good faith.[65] Both a breach of the UCC's implied covenant of good faith and fair dealing and a breach of the common law obligation generally give rise to a cause of action in contract.[66] Courts apply similar standards in UCC and common law cases to determine what constitutes a lack of good faith, taking into account all of the facts and circumstances surrounding the contract.[67]

In contrast to actions for breach of an implied covenant of good faith and fair dealing in contract, courts in a growing number of states now recognize in certain situations an action in tort for breach of an obligation to exercise good faith. Suit in tort provides an attractive alternative to an aggrieved party under a contract. If the offender's conduct is sufficiently culpable, a plaintiff may recover damages for emotional distress as well as punitive damages.[68]

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63. *See, e.g., supra* note 62; *see also* Fortune v. National Cash Register Co., 373 Mass. 96, 102, 364 N.E.2d 1251, 1257 (1977).

64. Brown-Marx Assocs., Ltd. v. Emigant Sav. Bank, 527 F. Supp. 277, 280 (N.D. Ala. 1981), *aff'd*, 703 F.2d 1361 (11th Cir. 1983); *see also* Brown v. Los Angeles County Superior Court, 34 Cal. 2d 559, 564, 212 P.2d 878, 881 (1949) (stating that "in every contract there is an implied covenant of good faith and fair dealing that neither party will do anything which injures the right of the other to receive the henefits of the agreement").

65. *See, e.g.*, Louderhack & Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F. L. REV. 187, 194 n.34 (1982) (tracing the development of common law concept of good faith and fair dealing in various cases).

66. *Id.* at 196. The authors discuss several common law cases recognizing a contract, hut not a tort, cause of action for breach of an implied covenant of good faith and fair dealing.

67. *Id.* at 194-95; *see also* Burton, *supra* note 13.

68. Most courts hold that a bad faith breach alone will not support an award of punitive damages absent some willful misconduct by the breacher. *See, e.g.*, First Nat'l Bank in Libby v. Twombly, 689 P.2d 1226 (Mont. 1984) (defining level of misconduct necessary to merit punitive damages awards). For a discussion of *Twombly*, see *infra* notes 134-39 and

According to commentators, the availability of punitive damages makes a tort suit "extremely attractive to plaintiffs whose compensatory damages are relatively insignificant but whose principal claim is based upon egregious conduct by the other contracting party."[69] In addition, damages in tort actions, as opposed to contract actions, are easier to demonstrate because the rule of *Hadley v. Baxendale*[70] requires plaintiffs suing in contract to prove reasonably foreseeable damages. Thus, lost profits recovery is more likely in a tort action than in a contract action.[71]

The tort of breach of an obligation of good faith in contract developed first in the context of insurance liability. In *Comunale v. Traders and General Insurance Co.*[72] an insurance company refused to settle a claim when there was a high risk of a judgment in excess of policy limits. The Supreme Court of California held that an action against the insurance company sounded in both tort and contract. The court reasoned that the insurance company's failure to consider the best interests of the insured constituted a breach of the company's obligation of good faith.[73] The California Supreme Court reaffirmed and elaborated on its *Comunale* opinion in *Crisci v. Security Insurance Co.*,[74] which upheld an award of tort damages against an insurance company by finding that the implied covenant of good faith and fair dealing required an insurer to settle within the policy limits, though the express terms of the policy did not impose this duty.[75] The tort of breach of the implied covenant of good faith in the insurance context rests on the premise that the insurer's obligation does not arise from the contract, but rather is imposed by law. In *Gruenberg v. Aetna Insurance Co.*[76]

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accompanying text.

69. Louderback & Jurika, *supra* note 65, at 205.

70. 9 Exch. 341, 156 Eng. Rep. 145 (1854). The rule of *Hadley v. Baxendale* permits a plaintiff to recover only general damages flowing from a breacb and only those consequential damages reasonably foreseeable at the time of the contract.

71. *See* Louderback & Jurika, *supra* note 65, at 204; Case Comment, *Sailing the Uncharted Seas of Bad Faith:* Seaman's Direct Buying Services, Inc. v. Standard Oil Co., 69 MINN. L. REV. 1161, 1166 (1985), *citing* Note, *Lost Profits and* Hadley v. Baxendale, 19 WASHBURN L.J. 488, 506-517 (1980).

72. 50 Cal. 2d 654, 328 P.2d 198 (1958).

73. *Id.* at 659, 328 P.2d at 201.

74. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

75. *Id.* at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16.

76. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *see also* Comment, *Good Faith and Fair Dealing in Insurance Contracts:* Gruenberg v. Aetna Insurance Co., 25 HASTINGS L.J. 699 (1974); Comment, *An Independent Duty of Good Faith and Fair Dealing in Insurance Contracts*—Gruenberg v. Aetna Insurance Co., 11 SAN DIEGO L. REV. 492 (1974). Several subsequent California cases also recognized the breach of an implied duty of good

the California Supreme Court explained this duty imposed by law by stating that "the insurer's duty is unconditional and independent of the performance of plaintiff's contractual obligations."[77]

Even though many jurisdictions now recognize both the implied covenant of good faith in contract and the duty of good faith imposed by law to allow tort recovery in insurance suits,[78] some courts still refuse to allow recovery in tort.[79] The creation of the tort of breach of the covenant of good faith in the insurance field demonstrates that strong public policy on a particular subject, such as the high expectations of the public when buying insurance, may cause courts to impose an obligation of good faith and fair dealing on contracts.[80] In addition to public policy, courts note other factors that allegedly make appropriate a recognition of tortious breach of the covenant of good faith in the insurance context. For example, the superior bargaining position of insurance companies with respect to the insured[81] and the fiduciary nature of the

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faith in the insurance context as tortious. *See, e.g.,* Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979); Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

77. 9 Cal. 3d at 578, 510 P.2d at 1040, 108 Cal. Rptr. at 488.

78. *See* Kornblum, *Recent Cases Interpreting the Implied Covenant of Good Faith and Fair Dealing,* 30 DEF. L.J. 411, 431-32 n.50 (1981) (collecting cases from various jurisdictions recognizing tort action for breach of the implied covenant of good faith in insurance contracts).

79. *See, e.g.,* Kewin v. Massachusetts Mut. Life Ins. Co., 409 Mich. 401, 423, 295 N.W.2d 50, 56 (1980) (declining to follow line of California insurance cases). A number of jurisdictions rejected an implied-in-law covenant of good faith and fair dealing in the insurance context, but then reconsidered. *See, e.g.,* Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980) (holding that the duty of an insurer to act in good faith is implied by law); A.A.A. Pool Serv. & Supply, Inc. v. Aetna Casualty & Sur. Co., 121 R.I. 96, 395 A.2d 724 (1978) (rejecting an implied-in-law covenant for fire insurance policies). Some jurisdictions imply the covenant at law for some types of insurance claims, but not for others. *See, e.g.,* Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 611 P.2d 149 (1980) (distinguishing first party insurance claims from third party claims).

80. *See, e.g.,* Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 819, 598 P.2d 452, 456, 157 Cal. Rptr. 482, 487 (1979); *see also* Graham & Luck, *The Continuing Development of the Tort of Bad Faith in Montana,* 45 MONT. L. REV. 43, 45-6 (1984) (discussing the expectations of an insured when buying the policy); Case Comment, *supra* note 71, at 1176-77. Louderback and Jurika note that vast numbers of people purchase some form of insurance and that a breach of good faith by an insurance company thus may affect dramatically the public good. Louderback & Jurika, *supra* note 65, at 216-20.

81. *See, e.g., Egan,* 24 Cal. 3d at 820, 598 P.2d at 457, 157 Cal. Rptr. at 487 ("the relationship of insurer and insured is inherently unbalanced"). Several courts have characterized insurance contracts as contracts of adhesion. *See, e.g.,* Schmidt v. Pacific Mut. Life Ins., 268 Cal. App. 2d 735, 74 Cal. Rptr. 367 (1969); Fitzgerald v. Aetna Ins. Co., 176 Mont. 186, 577 P.2d 370 (1978); *see also* Iron Mountain Sec. Storage Corp. v. American Specialty Foods, Inc., 457 F. Supp. 1158, 1167 (E.D. Pa. 1978). For a discussion of the characteristics of adhesion contracts, see Rakoff, *Contracts of Adhesion: An Essay in Reconstruction,* 96

duty owed to the insured[82] may support application of tort principles to insurance contracts. These factors exist in a variety of contractual situations, but the question remains unclear whether, under the analysis above, the tort of breach of the implied covenant of good faith can be applied to commercial contracts outside the insurance context.

2. Extension of the Tort to Other Contracts

In *Seaman's Direct Buying Service, Inc. v. Standard Oil Company of California*[83] the California Supreme Court acknowledged that the imposition of an implied-in-law duty of good faith might interfere with freedom of contract and refused to find the implied covenant in a commercial contract. The court recognized that tort damages can be recovered when a party attempts to shield itself from liability by denying the existence of a contract in bad faith.[84] The dissent argued for an extension of the implied covenant of good faith and fair dealing based on earlier California decisions and asserted that the reasonable expectations of the parties to every contract determine what conduct constitutes a tortious breach.[85] The dissent noted that public policy concerns and reasonable expectations of the parties already had prompted the extension of tort principles to a California case involving breach of

HARV. L. REV. 1174 (1983).

82. *See, e.g., Egan*, 24 Cal. 3d at 820, 598 P.2d at 457, 157 Cal. Rptr. at 487; *see also* Case Comment, *supra* note 71, at 1182-83 nn.75-78 (discussing the general characteristics of a fiduciary relationship).

83. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

84. *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363. The court did not decide whether tort liability could be imposed for breach of the implied covenant of good faith on the facts, and instead "created" a separate tort for bad faith denial of contract. *See* Case Comment, *supra* note 71, at 1168 (arguing that the *Seaman's* opinion "created the new tort . . . in order to avoid deciding whether to extend tort liability for breach of the implied covenant of good faith to the commercial context").

85. *Seaman's Direct*, 36 Cal. 3d at 777, 686 P.2d at 1172, 206 Cal. Rptr. at 368 (Bird, C.J., concurring and dissenting) (arguing that "[w]hile the extent of the duty varies from contract to contract, the duty itself inheres in *every* contract") (emphasis in original). Chief Justice Bird noted in her dissent that while the relationship between parties to an ordinary commercial contract necessarily differs from that of insurer to insured, a relationship nonetheless exists. Finally, the dissent rejected the danger that extension of the tort of breach of good faith would make every breach of contract a tort. Chief Justice Bird stated that most contract breaches do not involve bad faith conduct and that tort liability could not be imposed merely for bad faith breach of contract, but only for a failure to meet a duty imposed *ex delicto*. According to Chief Justice Bird's analysis, the reasonable expectations of the parties govern "the determination of what conduct constitutes a tortious breach." *Id.* at 779, 696 P.2d at 1174, 206 Cal. Rptr. at 370.

the implied obligation of good faith in the employment context.[86] In *Tamney v. Atlantic Richfield Co.*[87] an employee brought suit against his employer, alleging wrongful discharge and breach of an implied-in-law covenant of good faith and fair dealing, based on the employer's firing of the plaintiff for a refusal to commit criminal acts. The court held that tort remedies are available when the discharge of an employee contravenes the "dictates of public policy."[88] The court also indicated that the all powerful position of some employers creates a need for judicial protection of a wrongfully discbarged employees. Although the *Tamney* court specifically avoided the question of whether tort remedies are available for breach of the implied-at-law covenant of good faith, the majority concluded tbat the elements of a cause of action in tort would be identical to those of wrongful discharge.[89] In addition, the court cited several cases from other jurisdictions extending tort remedies for wrongful discbarge.[90]

Most courts have been unwilling to follow the broad suggestions made in some California cases that public policy concerns mandate the imposition by law of an obligation of good faith and fair dealing in every contract.[91] Rather, courts that accept the applicability of the tort outside insurance cases continue to apply the insurance analysis in deciding whether to extend the tort of breach of good faith and fair dealing to other areas.

The fiduciary or "special" quality of the relationship between the parties to a contract often will be the crucial factor in determining the availability of tort remedies, even in the insurance contract context. In *Farris v. United States Fidelity and Guaranty Co.*,[92] for example, the Supreme Court of Oregon decided a case in which an insurance company intentionally denied defense coverage to its insured despite apparent coverage of the claim under the

86. *Id.* at 775-76, 686 P.2d at 1171, 206 Cal. Rptr. at 367.

87. 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980).

88. *Id.* at 177, 610 P.2d at 1336, 164 Cal. Rptr. at 845.

89. *Id.* at 179 n.12, 610 P.2d at 1337 n.12, 164 Cal. Rptr. at 846 n.12.

90. *Id.* at 178, 610 P.2d at 1336, 164 Cal. Rptr. at 845 (collecting cases that recognize tort actions for employee discharge that contravenes public policy).

91. *See, e.g.*, Cleary v. American Airlines, Inc., 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980), in which a California court held that "[t]ermination . . . without legal cause after such a period of time offends tbe implied-in-law covenant of good faith and fair dealing contained in all contracts, including employment contracts." *Id.* at 455, 168 Cal. Rptr. at 729. While tbe opinion seems to suggest that an implied-in-law covenant exists in all contracts, the opinion does not further discuss applicability of the tort outside the employment area.

92. 284 Or. 453, 587 P.2d 1015 (1978).

policy. In rejecting the plaintiff's claim for damages due to emotional distress, the court found that no cause of action existed in tort for failure to pay an insurance claim. The court distinguished cases allowing tort recovery for failure of an insurance company to settle within policy limits on the grounds that a settling insurance company acts in a fiduciary capacity as an attorney representing the insured's interest in litigation.[93] The *Farris* court reasoned that the insurance company never undertook the fiduciary obligation to represent the interest of the insured; rather, the company refused any responsibility for the claim, constituting only a breach of contract.[94]

The Supreme Court of Montana recently has taken the initiative in extending the tort remedy for breach of the covenant of good faith and fair dealing on the combined bases of public policy, inequality of bargaining positions, and fiduciary responsibilities.[95] In *Dunfee v. Baskin-Robbins, Inc.*,[96] for example, that court allowed recovery in tort to a franchisee whose justifiable expectations were frustrated by his fiduciary, the franchisor. The same court also applied tort principles in *Nicholson v. United Pacific Insurance Co.*,[97] a case involving breach of a letter of intent to enter into a lease. The court's analysis focused on the conduct of the breaching party, rather than the existence of a breach, in upholding a jury award of punitive damages.[98] *Nicholson* expressly rejected the extension of an implied-in-law covenant of good faith

93. *Id.* at 460, 587 P.2d at 1019.

94. *Id.* at 468, 587 P.2d at 1023.

95. *See, e.g.,* Gates v. Life of Mont. Ins. Co., 668 P.2d 213 (Mont. 1983) (imposing legal duty on employers to act in good faith when dealing with employees); Weber v. Blue Cross of Mont., 196 Mont. 454, 643 P.2d 198 (1982) (holding that a health service corporation had a legal duty to act in good faith toward members given the inequality of bargaining positions); *see also* Graham & Luck, *supra* note 80 (discussing development of the tort in non-insurance cases).

96. 720 P.2d 1148 (Mont. 1986). In *Dunfee*, the Montana Supreme Court held that although a franchisor ordinarily does not owe a fiduciary duty to its franchisee, the plaintiff could obtain a recovery in tort if the franchisor unreasonably frustrated the justifiable expectation of its franchisee. *Id.* at 1153. Other cases also have upheld punitive damages awards in francbise situations. *See, e.g.,* Photovest Corp. v. Fotomat Corp., 606 F.2d 704 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980); Golf W. of Ky. v. Life Ins. Co., 178 Cal. App. 3d 313, 223 Cal. Rptr. 539 (1986); *see also* Brown, *Franchising-A-Fiduciary Relationship*, 49 TEX. L. REV. 650, 664-65 (1971). *But see* Case Comment, *supra* note 71, at 1185 n.85 (arguing tbat a franchisor-franchisee relationship does not give rise to a fiduciary relationsbip), *citing* Picture Lake Campground Inc. v. Holiday Inns, Inc., 497 F. Supp. 858, 869 (E.D. Va. 1980) *and* Chmieleski v. City Prods. Corp., 660 S.W.2d 275, 294-95 (Mo. Ct. App. 1983).

97. 710 P.2d 1342 (Mont. 1985).

98. *Id.* at 1348-51.

and fair dealing to every contract, but indicated that the law imposed such a duty on contracts characterized by adhesion and inequity.[99]

3. Implications for Financial Institutions

The issue also arises whether principles underlying the tort of breach of the implied-in-law obligation of good faith and fair dealing apply to contracts executed by financial institutions. Arguably, some factors present in banking and credit contracts exist also in an insurance contracts.[100] The public, for example, certainly demands stability and honesty in both the insurance industry and the banking system. The heavy regulation of banks and creditors by the UCC and other federal laws reflects the same public concern as the state regulation of insurance companies.[101] In addition, loan or credit agreements typically contain elements similar to those found in an adhesion contract for insurance.[102]

Two early California cases, however, indicate that the law historically imposed no tort duty of good faith on contracts executed by financial institutions. In *Sawyer v. Bank of America*[103] the California Court of Appeals overturned a jury award for punitive damages against a bank for an alleged breach of its obligation of good faith. The bank had failed to maintain insurance on the plaintiff's truck in violation of the terms of an oral agreement. Although the plaintiff-customer claimed that the bank's breach of the agreement caused him emotional distress, the court concluded that the bank's action did not amount to bad faith action extraneous to the contract. Because the law imposed no duty on the bank, the plaintiff could recover damages only for breach of contract.[104]

In *Wagner v. Benson*[105] the same court refused to acknowledge a bank's failure to disclose information regarding an investment loan to a borrower as a tortious breach of an obligation of good

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99. *Id.* at 1347.

100. *But see* Note, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing Into the Commercial Realm*, 86 COLUM. L. REV. 377 (1986). The author argues that banking contracts readily can be distinguished from insurance contracts even though some "special factors" are present. *Id.* at 398.

101. *See supra* note 5.

102. *See* Case Comment, *supra* note 71, at 1185 n.85 (noting that some bank contracts fit the model for an adhesion contract set forth in Rakoff, *supra* note 81, at 1177).

103. 83 Cal. App. 3d 135, 145 Cal. Rptr. 623 (1978).

104. *Id.* at 139, 145 Cal. Rptr. at 625.

105. 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980).

faith and fair dealing. The court recognized that a tort could arise from a borrower-lender relationship, but the majority found that the bank's action was not tortious.[106] The court held that the law could not impose duties on a lender for problems arising outside the scope of the contract.[107]

These early decisions imposing no extra-contractual duties on lenders, adopt the rule that the relationship of bank to depositor or creditor to debtor is not fiduciary in nature. The contract between depositor and bank creates a debtor-creditor arrangement that lacks the qualities of a fiduciary relationship.[108] Several factors, however, might be considered in establishing an implied-in-law fiduciary relationship. These factors include one party acting on behalf of the other, the exercise of influence by one party, the inequality of the parties, and the dependence of one party upon the other.[109] Some cases have found an implied fiduciary duty on the part of a creditor exercising excessive control over the business of a debtor, but courts appear unwilling to embrace this position except in extreme situations.[110]

Thus far, at least one court has implicitly rejected the extension of tort remedies to a lender-borrower relationship. In *Brown-Marx Associates, Ltd. v. Emigrant Savings Bank*[111] the plaintiff brought suit against a bank for breach of a loan commitment. The court acknowledged that an implied covenant of good faith and fair dealing arising from the contract governed the loan agreement, but distinguished that covenant from the tort duty of good faith imposed on a contract by law. The tort duty arises either to further some social policy or when the relationship of the parties implies the duty.[112] The court concluded that the law imposed no

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106. *Id.* at 34, 161 Cal. Rptr. at 520-21.

107. The court stated that "[t]he success of the Wagners' investment [was] not a benefit of the loan agreement which the Bank [was] under a duty to protect." *Id.* at 34, 161 Cal. Rptr. at 521.

108. *See, e.g.*, Westerly Community Credit Union v. Industrial Nat'l Bank, 103 R.I. 662, 668, 240 A.2d 586, 589 (1968) (stating that "the contract of deposit causes a debtor-creditor relationship"); *see also* Case Comment, *supra* note 71, at 1185 n.85, *citing* Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, 731 F.2d 112, 122 (2d Cir. 1984).

109. *See* First Bank of Wakeeney v. Moden, 235 Kan. 260, 262, 681 P.2d 11, 13 (1984).

110. In State National Bank of El Paso v. Farah Manufacturing Co., Inc., 678 S.W.2d 661 (Tex. Ct. App. 1984), plaintiffs dropped the claim for fiduciary breach because the claim would have been difficult to prove. *See* Ebke & Griffin, *supra* note 8, at 795 n.120. *See generally*, Lundgren, *Liability of a Creditor in a Control Relationship with Its Debtor*, 67 MARQ. L. REV. 523 (1984).

111. 527 F. Supp. 277 (N.D. Ala. 1981).

112. *Id.* at 283.

duty on the bank to act in good faith toward its borrower sufficient to justify the recovery of tort damages for breach of a loan agreement.[113] Taken together, these cases demonstrate that, despite similarities in the activities of creditors and insurance companies, financial institutions generally have not been subject to tort liability for breach of the implied-in-law obligation of good faith and fair dealing.

III. Recent Developments

A. K.M.C. Co., Inc. v. Irving Trust Co.

The most notable development in the recent trend toward expansion of lender liability is *K.M.C. Co., Inc. v. Irving Trust Co.*[114] in which the Sixth Circuit affirmed a seven and one half million dollar jury award against Irving Trust for bad faith breach of a financing agreement. K.M.C., a grocery retail company, brought suit against Irving Trust when the bank suddenly refused to advance funds to the business under a three and one half million dollar line of credit agreement. Under the terms of the financing agreement, Irving Trust retained a security interest in all accounts receivable, which the bank required K.M.C. to place in a special "blocked account" to which the bank had sole access. In March 1982 Irving Trust refused to advance 800,000 dollars to K.M.C., despite the fact that this loan would not exceed the three and one half million dollar limit. Three days after the bank's initial rejection of K.M.C.'s request, the bank decided to advance the money. During the intervening period, K.M.C. suffered a loss of credit standing, and the company collapsed. At trial, the court instructed the jury that the obligation of good faith implied in every contract may have imposed a duty on Irving Trust to give notice to its borrower of any refusal to lend under the agreement, unless the bank made its decision in good faith and in the reasonable exercise of its discretion.[115] The damages awarded to K.M.C. were based on the difference between the value of the company in terms of what an acquirer would pay prior to the company's collapse and the value of the company after the bank's refusal to advance funds.[116]

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113. *Id.*
114. 757 F.2d 752 (6th Cir. 1985).
115. *See id.* at 759.
116. *See id.* at 764. The district court opinion upheld the award of damages. *See* K.M.C. Co., Inc. v. Irving Trust Co., No. 3-82-365, slip. op. at 14 (E.D. Tenn. filed July 22, 1983).

On appeal, the Sixth Circuit affirmed the jury verdict and upheld the damage award as "within the reasonable range."[117] In considering whether the trial court's instruction was correct, the court of appeals first recognized that the "blocked account" procedure established by the agreement effectively precluded K.M.C. from obtaining alternate financing. The court further stated that the "blocked account" mechanism left "K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance."[118] Thus, the court concluded that good faith performance of this financing arrangement required notice of refusal to lend, unless a valid business reason existed for failure to give notice.[119] In the court's view, refusal to lend without prior notice constituted an abuse of the bank's wide discretion. In support of this requirement of notice, the court cited UCC section 2-309 comment 8 dealing with notice of termination of a going contract.[120]

Irving Trust cited both *Grandin*[121] and *Midlantic*[122] to show that the financing agreement did not legally obligate the bank to advance funds. The court, however, distinguished these Florida cases because neither examined a good faith limitation on the bank's discretion. In addition, the Sixth Circuit emphasized Irving Trust's inordinate amount of control over K.M.C. and the established course of dealing between the parties.

The court next considered Irving Trust's claim that the demand provision in the financing agreement allowed the bank to demand repayment of the entire loan at any time and to refuse to lend further amounts. Citing both *Brown v. AVEMCO*[123] and UCC section 1-208, the court stated that a bank's power to demand re-

117. The court upheld the jury award, concluding that the proper measure of damages equaled the difference between the K.M.C.'s value prior to the bank's negative decision and the value of the company on the market after the decision. The court found the testimony of several experts an acceptable basis upon which to compute the approximate values. *Irving Trust*, 757 F.2d at 763-66.

118. *Id.* at 759.

119. *Id.* Jewell v. Bank of Am., No. 112439 (Sonoma County Cal. Super. Ct. 1985), pending on appeal, may present similar arguments for liability. The counterclaim asserted fraud, as well as breach of good faith. *See* Sudo, *supra* note 3.

120. *Irving Trust*, 757 F.2d at 759. UCC § 2-309 comment 8 pertains to sales contracts and states: "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."

121. For a discussion of *Grandin*, see *supra* notes 50-52 and accompanying text.

122. For a discussion of *Midlantic*, see *supra* notes 53-55 and accompanying text.

123. For a discussion of *AVEMCO*, see *supra* notes 39-43 and accompanying text.

payment, like its discretion over whether to advance loans, is limited by an obligation of good faith performance. According to the court, the demand provision acted as a type of acceleration clause, on which the UCC and the courts impose obligations of reasonableness and fairness.[124] The majority then determined whether Irving Trust exercised good faith in refusing to lend money to K.M.C. without notice, applying both objective and subjective standards to ascertain whether the bank's employee believed in good faith that K.M.C.'s financial difficulties jeopardized the loan. Although the evidence conflicted as to whether K.M.C.'s financial condition was actually worsening or improving, the court found that Irving Trust previously had monitored the company and was well aware of its difficulties. Finding also that Irving Trust was not faced with a sudden crisis on the date of the refusal, the court held that a jury could have determined that no reasonable loan officer would have refused a loan request under similar circumstances.[125]

B. Commercial Cotton Co. v. United California Bank

In *Commercial Cotton Co. v. United California Bank*[126] a bank appealed from a judgment in favor of its customer, Commercial Cotton Company. The customer brought suit after the bank negligently paid two checks containing unauthorized signatures and then refused to recredit the account. The judgment awarded Commercial Cotton 4000 dollars for the negligent payments, 20,000 dollars for intentional infliction of emotional distress, and 100,000 dollars in punitive damages for breach of the covenant of good faith and fair dealing implied in the contract between a bank and its depositor.[127]

On appeal, the California Supreme Court upheld the awards for negligent payment and breach of the covenant of good faith, but reversed the award for infliction of emotional distress.[128] The court acknowledged that the tort of breach of the covenant of good faith and fair dealing could be applied in cases outside of the insurance contract context.[129] The court also emphasized that *Sea-*

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124. 757 F.2d at 760.

125. *Id.* at 762-63 (stating that "generally there was ample evidence . . . that March 1 simply was not that unusual a day in the history of the relationship between Irving and K.M.C."). *Id.* at 762.

126. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

127. *Id.* at 514-15, 209 Cal. Rptr. at 553.

128. *Id.* at 516-17, 209 Cal. Rptr. at 554-55.

129. *Id.* at 516, 209 Cal. Rptr. at 554.

man's Direct did not expressly preclude application of the doctrine to ordinary commercial contracts.[130]

The court recognized similarities between insurance contracts and contracts between a bank and its customers. First, the court noted that the government regulates the banking system as heavily as the insurance industry. Notwithstanding these protections, the bank customer relies almost exclusively on the financial institution's "honesty and expertise" in handling funds.[131] Furthermore, the bank stands in a superior bargaining position in relation to its customer. Finally, the court noted that the banking system, like the insurance industry, provides "vital public services substantially affecting the public welfare."[132] Thus, the court held that the relationship of bank to depositor is "at least quasi-fiduciary"[133] and that, as a result of this relationship, the bank's behavior constituted a breach of the covenant of good faith and fair dealing imposed by law.

C. *The Montana Cases*

1. *First National Bank in Libby v. Twombly*

In *First National Bank in Libby v. Twombly*[134] a bank brought suit to recover a deficiency judgment on a promissory note and security agreement. The borrowers defaulted on the loan payments, but negotiated a restructuring of the loan with a bank agent who failed to inform the bank officers. Later, the bank without notice accelerated the entire debt and offset the outstanding obligation against funds in the borrower's checking account. The bank brought suit for the balance owing on the note. The borrower, however, counterclaimed that the bank previously had assured him that the loan would be refinanced and that the acceleration breached the bank's implied covenant of good and fair dealing.[135] The jury found that the bank breached its good faith obligation in accelerating the debt, but awarded only 4000 dollars in compensatory damages.[136]

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130. *Id.* For a discussion of *Seaman's Direct*, see *supra* notes 83-86 and accompanying text.

131. *Commercial Cotton*, 163 Cal. App. 3d at 516, 209 Cal. Rptr. at 554.

132. *Id.*

133. *Id.*

134. 689 P.2d 1226 (Mont. 1984).

135. *Id.* at 1228-29.

136. *Id.* at 1227.

On appeal, the Supreme Court of Montana concluded that the issue of punitive damages should have been submitted to the jury. The court began its analysis by noting that Montana's version of the UCC, particularly section 1-208 on acceleration at will, applied to the transaction in question. The court, however, warned that the case presented a rather unusual fact situation.[137] Although the jury found that the bank violated the statutorily imposed good faith provisions of sections 1-203 and 1-208, the jury did not consider punitive damages.

Without any substantial elaboration, the court stated that when the duty to exercise good faith is imposed by law rather than the contract itself, the breach of that duty is tortious.[138] Under the court's analysis, punitive damages for a tortious breach of a statutory obligation would be recoverable only when the conduct of the breacher is "sufficiently culpable," or where "malice, oppression or fraud" motivates that conduct.[139] The court concluded that, on the basis of the evidence presented, the jury could have found that the bank acted in sufficiently reckless disregard of the borrower's rights to support an award of punitive damages.

2. *Tribby v. Northwestern Bank of Great Falls*

In *Tribby v. Northwestern Bank of Great Falls*[140] the Montana Supreme Court applied its *Twombly* analysis to another lender liability suit. In *Tribby* a depositor brought suit against its bank, alleging wrongful payment on checks drawn on a partnership account that did not contain two authorized signatures. In addition, the depositor claimed that the bank, in breach of its obligation to act in good faith, subsequently refused to make personal loans in retaliation for the suit brought on behalf of the partnership.[141] The jury awarded 119,000 dollars in compensatory damages.

Although the appellate court did not indicate whether the UCC or some other statute imposed a good faith obligation on the bank, the *Tribby* opinion indicated that punitive damages were properly recoverable.[142] The court noted that while *Twombly* sup-

137. *Id.* at 1230.
138. *Id.*
139. *Id.* Courts generally hold that plaintiff must show culpable conduct to recover punitive damages.
140. 704 P.2d 409 (Mont. 1985).
141. *Id.* at 413.
142. *Id.* at 419.

posedly presented a unique case, similar factors, such as the superior bargaining power of the bank, allowed the jury to find that the bank acted in reckless disregard of customer rights. The court, however, carefully limited its holding by saying that the opinion did not extend the obligation of good faith implied by law to every contract.[143]

3. *Central Bank of Montana v. Eystad*

In *Central Bank of Montana v. Eystad*[144] the Montana Supreme Court considered another claim against a bank for breach of the covenant of good faith and fair dealing. The bank and the borrowers had executed a loan, which the bank extended several times on the condition that the borrowers substantially reduce the total amount owed. Subsequently, the bank refused to further extend the due date for the loan and foreclosed on parcels of land that served as security for the debt. The parties had an established business relationship, and the borrowers claimed that the "course of conduct" in extending the loan estopped the bank from foreclosing. According to the borrowers, foreclosure breached the bank's obligation of good faith and fair dealing owed to its customer.[145]

The court affirmed a finding for the bank by stating that Central Bank was not bound by an implied-in-law covenant of good faith and fair dealing, but was bound by the obligation of good faith, defined as honesty in fact and imposed on every contract or duty within the Uniform Commercial Code.[146] The court concluded that the bank had acted candidly and reasonably so that even if an implied-in-law covenant of good faith had existed, it would not have been breached by the bank on these facts. The court further stated that breach of a statutory covenant imposed by section 1-203 would not support an award of punitive damages absent a showing of malice, fraud, or oppression.[147]

IV. Analysis

A close reading of the recent cases applying some concept of a covenant of good faith and fair dealing to banks and creditors demonstrates a judicial dilemma. Courts recognize the potential for

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143. *Id.*
144. 710 P.2d 710 (Mont. 1985).
145. *Id.* at 713.
146. *Id.* at 714.
147. *Id.*

abuse in bank-customer and creditor-debtor relationships and attempt to reach correct results by means of good faith. Courts strive also to follow precedent and to avoid an overly broad interpretation of implied covenants of good faith and fair dealing in commercial contracts. Furthermore, in applying either UCC or common law principles of good faith, courts often must choose between the competing policies of compensating plaintiffs and preservation of the freedom of contract in the banking and credit context.

A. *Evaluating Judicial Application of the UCC Covenant of Good Faith and Fair Dealing to Financial Institutions*

In *K.M.C. Co., Inc. v. Irving Trust Co.*[148] the Sixth Circuit began its analysis by noting that section 1-203 of the UCC imposed a duty on Irving Trust to act in good faith toward K.M.C. in carrying out the spirit of the credit arrangement. Although the agreement did not expressly provide for notice, the covenant of good faith arising from the contract required that notice be provided to the borrower of refusal to lend consistent with the spirit of the bargain. Thus, the court imposed a notice requirement that allowed the covenant of good faith and fair dealing under the UCC to mandate conduct necessary for carrying out the expressions of the parties.[149]

In addition, the Sixth Circuit indicated that Irving's ability to call the loan as a type of demand note would be subject to the good faith limitations of section 1-208.[150] Based on these limitations, the court rejected Irving's argument that because the credit arrangement contained a demand provision, the bank had the authority to demand payment at any time, which necessarily involved a refusal to lend further funds. The court apparently adopted a good faith requirement for the calling of the demand note as well as for the lender's refusal to advance funds.[151] Thus, the Sixth Circuit appeared to apply a two-tiered analysis to the bank's decision, using sections 1-203 and 1-208 to uphold the award for contractual damages.[152]

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148. 757 F.2d 752 (6th Cir. 1985). For a discussion of *Irving Trust*, see *supra* notes 114-25 and accompanying text.

149. *See supra* notes 24-25 and accompanying text.

150. *But see supra* notes 31-38 and accompanying text.

151. 757 F.2d at 760. Although the court cited UCC § 1-208 and *AVEMCO* in support of its ruling that Irving's call of a demand note would be limited by § 1-208, the official comment to § 1-208 expressly exempts demand notes.

152. *Id.* at 763-66. The award was based on the difference between the value of

Subsequent cases have explicitly rejected the Sixth Circuit's apparent application of the section 1-208 requirements of good faith to the calling of a demand note. In *Flagship National Bank v. Gray Distribution Systems, Inc.*[153] a Florida court reversed a jury award of 3.2 million dollars in punitive and compensatory damages against a bank that refused to continue loans under a financing arrangement. The court, citing *Grandin* and *Midlantic*, found that the financing arrangement created no obligation on the bank to continue funding.[154] Moreover, the court refused to follow *Irving Trust*, calling the Sixth Circuit's imposition of obligations of good faith on demand notes "suspect."[155]

The bankruptcy court in *In re Red Cedar Construction Co.*[156] declined to interpret *Irving Trust* as imposing the section 1-208 good faith requirements on all demand notes. Rather, the court explained that the agreement in *Irving Trust* created an irrevocable commitment by Irving to lend funds as long as an express agreement existed and the borrower objectively qualified for the loan.[157] In contrast, a true demand note would create only a revocable commitment to lend, and the good faith principles of 1-208 would not apply.[158] Thus, the bankruptcy court concluded that the Sixth Circuit merely adopted good faith standards comparable to those used in application of section 1-208 for future advances when the commitment to lend is irrevocable and the bank has an obligation to lend to a qualified borrower. Under the bankruptcy court's analysis, a lender would breach the obligation of good faith only by failing to make a loan under an irrevocable loan commitment to a borrower objectively qualified for a loan. The bankruptcy court interpreted the *Irving Trust*'s requirement of notice to be inapplicable to situations in which the debtor's ability to pay or perform is in fact impaired.[159]

K.M.C. as a going concern before the bank's refusal to lend and the company's value after the refusal. *See supra* notes 56-62 and accompanying text.

153. 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986).

154. *Id.* at 1340. The court found that good faith could not be invoked to override express terms of a contract.

155. *Id.* at 1341.

156. 63 Bankr. 228 (Bankr. W.D. Mich. 1986).

157. *Id.* at 237.

158. *Id.* at 238 n.7. The bankruptcy court concluded that the funding arrangement in *Irving Trust* was an irrevocable commitment to lend because the Sixth Circuit rejected a suggestion tbat the demand provision in the agreement gave Irving Trust the right to refuse to lend without notice. The bankruptcy court focused its analysis on the existence of a written agreement between Irving Trust and K.M.C. *Id.* at 237-38.

159. *Id.* at n.8.

The bankruptcy court, ignoring several important implications of the Sixth Circuit's opinion, refused to place a good faith obligation to provide notice on a lender who refused to advance funds. Although correctly interpreting the Sixth Circuit's adoption of good faith requirements for future advances, the bankruptcy court's analysis removes a good faith obligation of notice in most refusals to lend because many credit arrangements are revocable. In addition, notice would be excused when the creditor could not demonstrate "objective creditworthiness"—a determination that under *Irving Trust* should be made in good faith.

An alternative interpretation to the Sixth Circuit's application of good faith principles, contrary to the view taken by *Flagship*,[160] is that *Irving Trust* should not be read to extend section 1-208 to refusals to lend. Rather, the Sixth Circuit merely recognized the obligation to act in good faith under section 1-203 and then determined that notice of refusal and good faith belief in insecurity were necessary to carry out the spirit of the bargain agreed to in the particular contract signed by the particular parties.[161] In *Irving Trust* the Sixth Circuit faced a unique situation in which the use of a blocked account gave the bank extraordinary discretion. The bank's grant of a loan three days after its initial refusal suggests that the initial refusal may have been in bad faith. Thus, the court applied section 1-203 to require notice of refusal as well as good faith in the bank's decisionmaking, to be measured not under section 1-208 itself, but under standards similar to those employed by courts considering good faith in the acceleration context.

The latter interpretation of *Irving Trust* arguably reads obligations of good faith into agreements for all lines of credit in which the lender retains discretion over the advance of funds. This reading might be supported by the Sixth Circuit's reference to *Brown v. AVEMCO*,[162] in which the Ninth Circuit implicitly suggested that the section 1-208 requirements always should apply to accelerations initiated at the option of the creditor. It seems unlikely, however, that courts would follow such a sweeping limitation on loan agreements expressly discretionary in nature, especially when these agreements clearly represent the expectations of both parties. The issue arises whether a court may use section 1-203 to imply additional good faith requirements to a contract that expressly

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160. For a discussion of *Flagship*, see *supra* notes 153-55 and accompanying text.

161. *See supra* notes 24-25 and accompanying text.

162. 603 F.2d 1367 (9th Cir. 1979). For a discussion of *AVEMCO*, see *supra* notes 39-43 and accompanying text.

delineates the rights and obligations of the parties concerning good faith and notice of refusal to lend.[163] The court in *Irving Trust* did not address whether parties could, in effect, preclude a court from requiring notice by addressing it in the contract. If *Irving Trust* is read as a contract case, authority exists in certain franchise contract termination cases that by analogy would allow banks to avoid the *Irving Trust* dilemma through skillful contract drafting.[164] Regardless of which interpretation prevails, *Irving Trust* stands for the proposition that section 1-203 confers upon the courts the power to imply obligations of good faith into ambiguous agreements. *Irving Trust* also may signal an increased willingness by courts to hold banks and creditors to higher standards.

In *Irving Trust* the Sixth Circuit also confronted the dilemma of how to award damages to the aggrieved borrower who lost an entire business as a result of the bank's misconduct. The UCC limited the court to an award of contract damages, an award that would put K.M.C. in as good a position as if the bank had performed. By upholding the difference in value between the worth of K.M.C. before and after the bank's breach of the covenant as the proper measure of damages, the court, in effect, compensated K.M.C. for future profits, which courts generally hold too uncertain to prove with the accuracy needed to justify an award in contract.[165]

Some commentators suggest a modification of traditional concepts of contract damages as a solution to the problem of cove-

163. *See supra* note 21 and accompanying text.

164. *See, e.g.*, Division of Triple T Serv., Inc. v. Mobil Oil Corp., 60 Misc. 2d 720, 304 N.Y.S.2d 191 (1969), *aff'd without opinion*, 34 A.D.2d 618, 311 N.Y.S.2d 961 (1970). In *Division of Triple T*, the franchisee sought an injunction preventing the franchisor from terminating the franchise agreement. The franchise contract expressly allowed termination of the agreement by either party at the end of an original three-year period or at the end of any three-year renewal period by written notice given 90 days before the desired termination. The contract also allowed the franchisor to terminate on 30 days' notice during the first year of the agreement. 60 Misc. 2d at 722, 304 N.Y.S.2d at 194. At the end of the original three-year term, the franchisor notified the franchisee of termination by the franchisor due to "inadvisability" of renewal. *Id.* The franchisee claimed that the termination lacked the good faith required in the performance of every contract under the UCC. Although the New York court recognized that a franchisor often possesses superior bargaining power in dealing with a franchisee, the court held that the UCC imposed no obligation on the franchisor to act in good faith when terminating the franchise agreement according to the terms of the contract. The court simply stated that "unless the termination clause be deemed unconscionable there is no implicit requirement that it be exercised other than as provided for in the contract." *Id.* at 729, 304 N.Y.S.2d at 201.

165. *See supra* note 71.

nants of good faith in the banking context.[166] These writers propose that in extraordinary circumstances, such as in *Irving Trust*, a plaintiff should receive adequate compensation by means of adjusted contract damages that would depend on such circumstances as willful misconduct. In these cases, the bank would not be able to escape excessive monetary awards by hiding behind the protection of ordinary contract damages. This approach would preserve the principles of freedom of contract and "efficient breach" of commercial contracts[167] and would protect the banking and credit system from uncontrolled punitive damage awards.

B. Evaluating Judicial Extension of the Tort of Breach of Good Faith and Fair Dealing to Financial Institutions

The sporadic application of the tort of breach of an implied-at-law duty of good faith and fair dealing in banking and credit situations suggests that courts are taking an ad hoc, even cautious, approach. Courts increasingly recognize that bank and credit contracts may create a special relationship between the parties. *Irving Trust*, for example, could be read to imply that, as a result of the blocked account procedure, the bank stood in a quasi-fiduciary relationship to its borrower.[168] This special or quasi-fiduciary relationship justifies judicial protection only in extraordinary situations.

Courts have not cbaracterized the bank-customer relationship as fiduciary in nature, but at least one case, *Commercial Cotton v. United California Bank*,[169] demonstrates the willingness of Cali-

166. *See, e.g.*, Case Comment, *supra* note 71, at 1186-96. The author of the case comment recognizes that simple contract damages may not provide adequate compensation when a breach of contract occurs in bad faith, yet asserts that rationales for allowing tort damages, such as deterrence of misbehavior, do not exist in commercial contract situations. The author argues for a modification of ordinary contract damages on a case-by-case basis, involving such steps as relaxation of proof required for lost profit recovery. *Id.* at 1193; *see also* 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, 443 (1981) (arguing for greater sanctions for a willful hreach of contract only as a method for leaving contract principles intact); Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1476-77 (1980) (suggesting "supercompensatory" damages for some breaches of contract, including those occurring in bad faith).

167. The concept of an efficient breach of contract gives the breacher justification for nonperformance of an economically undesirable contract. *See* Diamond, *supra* note 166, at 433 (stating that efficient breach is a judicially accepted principle of contract law).

168. *See* K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752, 759 (6th Cir. 1985).

169. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985). For a discussion of *Commercial Cotton*, see *supra* notes 126-32 and accompanying text; *see also* Seaman's Direct Buying Serv., Inc. v. Standard Oil Co. of Cal., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354

fornia courts to recognize the ordinary bank-customer relationship as a special one. *Commercial Cotton* characterized the bank contract as an object of public concern because of widespread effects and the dependence of ordinary depositors on the expertise of the bank in handling funds. Moreover, bank deposit contracts are not bargained for, and most credit arrangements contain elements of adhesion. As a matter of social policy, therefore, some courts may compensate plaintiffs and punish banks through awards of punitive damages.

While California appears on the brink of requiring banks to act in good faith in all situations, other states, such as Montana, recognize the danger of extending this tort to all banking relationships. The Montana Supreme Court, on facts the court termed "unique," allowed tort damages against a bank in *First National Bank in Libby v. Twombly*[170] on the basis of a section 1-203 covenant of good faith and fair dealing. The court apparently overlooked or ignored the express limitation of damages for breach of a UCC duty contained in section 1-106.[171] Despite the supposed unique characteristics of the fact situation in *Twombly*, the same court again held the tort of breach of the implied covenant of good faith and fair dealing applicable to a financial institution in *Tribby v. Northwestern Bank of Great Falls*.[172] In *Tribby*, however, the court did not identify the source of this implied-at-law covenant and specifically rejected the opportunity to extend the tort for breach of good faith to every contract.

In *Central Bank of Montana v. Eystad*[173] the Montana Supreme Court abruptly backed away from its apparent trend toward incorporation of tort principles for breach of an implied-at-law covenant of good faith in all contracts involving financial institutions. *Eystad*, however, presented a fact situation similar to both *Twombly* and *Tribby*, which involved ordinary customers protesting unilateral action taken by their bank. In *Eystad* the bank foreclosed on security after refusing to extend a loan. Similarly, *Twombly* involved the acceleration of a debt. In *Eystad*, however,

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(1984) (characterizing a "special" relationship as one deserving of judicial protection); Robinson v. Texas Commerce Bank, No. C-1948-84 (Hildago County Tex. Dist. Ct. 1987) (jury determination that relationship between the bank and its customer was "special").

170. 689 P.2d 1226 (Mont. 1984).

171. *See supra* note 56 and accompanying text.

172. 704 P.2d 409 (Mont. 1985). For a discussion of *Tribby*, see *supra* notes 140-42 and accompanying text.

173. 710 P.2d 710 (Mont. 1985). For a discussion of *Eystad*, see *supra* notes 144-47 and accompanying text.

the court refused to acknowledge a covenant of good faith and fair dealing other than the one arising from the contract under the UCC.

Arguably, both *Twombly* and *Tribby* involved a degree of culpable behavior by tbe banks. In *Twombly* the bank foreclosed and accelerated the debt despite assurances that the loan would be refinanced. Similarly, in *Tribby* the customer alleged that the bank consciously refused to make personal loans in retaliation for a suit initiated on a separate matter by the same applicant. In *Eystad* the court found the bank's refusal to extend the date of the loan and subsequent foreclosure plainly within the bank's rights. Thus, the *Eystad* court ignored the bank's previous extensions and chose not to characterize the bank's action as sufficiently culpable to warrant tort damages.

The Montana cases involving financial institutions represent the broad judicial discretion exercised by courts in applying the tort of breach of good faith. As *Twombly*, *Tribby*, and *Eystad* demonstrate, courts often will engage in line-drawing between relative degrees of misconduct by financial institutions and refuse to extend the tort wholesale to all banking and creditor relationships. The ad hoc application of the tort of breach of an implied-at-law covenant of good faith and fair dealing is based on the recognition that traditional contract damages may be inadequate compensation for some bank and credit customers.[174] The high cost of litigation and the difficulty of proving contract damages may deter plaintiffs, especially the average bank customer, from bringing suits. This deterrence would grant financial institutions the license to abuse their superior bargaining position.[175] Thus, *Twombly* and *Tribby* may evidence a judicial desire to protect a special type of commercial contract between an unsophisticated consumer and a bank.

On the other hand, several arguments have been proposed against the extension of this tort to contractual financial dealings between businesses and creditors. First, the principle of freedom of contract between parties of equal bargaining power underlies all commercial contracts, and the imposition of additional obligations may be unnecessary. Second, application of tort principles to a breach of contract essentially eliminates the concept of an efficient

174. *See supra* note 166.

175. *See* Diamond, *supra* note 166, at 451 (suggesting that in transactions involving consumers, expenses of litigation might exceed the damages recovered so that consumers are less likely to bring suit and bad faith breach is encouraged).

breach. Third, allowing tort damages might encourage frivolous litigation by businesses looking for a way to recover economic losses.[176] Finally, the possibility of punitive damages in the commercial context threatens the stability and soundness of the banking system.[177] Some argue that banks, like insurance companies, could pass on large punitive damage awards to the public as a cost of doing business. The potentially staggering liability, however, could result in both bank failures and an undesirable tightening of credit.[178]

Thus, courts allowing tort recovery for an implied-in-law covenant of good faith and fair dealing in cases involving the liability of financial institutions arguably have set a dangerous precedent. With the exception of California, however, most state courts continue to reject the application of this tort to banks and creditors. The Montana cases, on tbe other hand, demonstrate that some states will apply the covenant of good faith and fair dealing, but on an ad hoc basis.

V. Conclusion

In *Irving Trust* the Sixth Circuit approached the issue of liability under the UCC by interpreting the "spirit" of a loan agreement as imposing obligations of good faith on the bank. The court was within its authority to find that the nature of the contract required notice and good faith decisionmaking. The court's innovative method of computing the contractual damage award, however, stands as an ominous precedent for courts that are unwilling to impose a tort duty on banks on the basis of a covenant of good faith. The UCC duty of good faith in contract, therefore, is a powerful tool that courts increasingly may apply to banks and creditors in particularly egregious circumstances because of public concern over the control of financial institutions. In a similar vein, courts that recoguize the tort of breach of good faith in the law of

176. *See id.* at 449.

177. *See* Ebke & Griffin, *supra* note 8, at 800-05.

178. *Id.* at 801 n.155. The authors include excerpts from the Amicus Curiae Brief for the Missouri Bankers Association in Support of Appellant-Respondent Centerre Bank of Kansas City, N.A., *reprinted in* 2 Emerging Theories of Lender Liability 1195-96 (H. Chaitman ed. 1985). The Association argued that

> loose application of an undefined and unlimited liability theory . . . could wreak havoc on the ability of . . . banks te make proper evaluation. Thus, faced with uncertain risks and potentially enormous liability . . . banks likely will be forced to change the terms and increase the cost at which financing is made available to . . . borrowers.

Id.

insurance contracts may apply the same concepts to banking contracts. Most courts are unlikely to extend the tort to all cases involving financial institutions, but extraordinary circumstances may prompt courts to allow plaintiffs recovery in tort.

Common law and UCC concepts of good faith and fair dealing have been recognized for some time. As applied to financial institutions, however, these concepts are indeed potential loose cannons of liability. Courts will invoke these concepts on a case-by-case basis. While courts apparently will not apply the doctrines to every case involving a financial institution, the power of courts to invoke the concept of good faith as a basis for large damage awards should concern banks and creditors alike.

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