

Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*

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The question of lender liability is now a favorite subject in the law.¹ In the past few years, numerous lender liability theories have emerged on a case-by-case basis.² Among the liability theories that have developed in this ad hoc fashion, the doctrine of good faith and fair dealing plays relatively little role.³ The doctrine of good faith and fair dealing traditionally has not been relied upon by courts as a primary theory of lender liability; rather, it is considered as a possible basis of civil liability in connection with other more established liability theories. Because of its inherent flexibility and the resulting potential for expansion, the doctrine of good faith and fair dealing may, however, gain significance in commercial lending transactions in the years to come.

Conceptually, the doctrine of good faith and fair dealing is on the borderline between contract law and tort law.⁴ As one prominent commentator has observed, the distinction between contract and tort liability as between contracting parties has

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1. See Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775, 800-16 (1986) [hereinafter Ebke & Griffin], revised and reprinted in 10 PUBLICATIONS OF THE JAPANESE INSTITUTE OF COMPARATIVE LAW 49 (K. Yamauchi ed. 1987).

2. See 1-3 EMERGING THEORIES OF LENDER LIABILITY (H. Chaitman ed. 1985). See also BURKE, THOMAS & WARREN, *Emerging Theories of Bank Liability*, in BANKS AND THEIR BORROWERS: NEW OPPORTUNITIES IN FINANCIAL SERVICES 403 (1984); Bahls, *Termination of Credit for the Farm or Ranch: Theories of Lender Liability*, 48 MONT. L. REV. 213 (1987); Bartlett & Lapatin, *The Status of a Creditor as a "Controlling Person,"* 28 MERCER L. REV. 639 (1977); Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975); Ebke & Griffin, *supra* note 1, at 782-800; Ellis & Gray, *Lender Liability for Negligently Processing Loan Applications*, 92 DICK. L. REV. 363 (1988); Flick & Replansky, *Liability of Banks to Their Borrowers: Pitfalls and Protections*, 103 BANKING L.J. 220 (1986); Granoff, *Emerging Theories of Lender Liability: Flawed Applications of Old Concepts*, 104 BANKING L.J. 492 (1987); Kunkel, *The Fox Takes Over the Chicken House: Creditor Interference with Farm Management*, 60 N.D.L. REV. 445 (1984); Lundgren, *Liability of a Creditor in a Control Relationship with Its Debtor*, 67 MARQ. L. REV. 523 (1984); Norton, *Theories of Lender Liability: Practical Lessons for Lenders and Counsel*, 23 ST. B. TEX., BULL. SEC. ON CORP., BANKING & BUS. L., Feb. 1986, at 2; Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411 (1987); Wright, *Creditor Liabilities in Farm Lending*, 38 ALA. L. REV. 763 (1987); Note, *Insights into Lender Liability: An Argument for Treating Controlling Creditors as Controlling Shareholders*, 135 U. PA. L. REV. 1321 (1987).

3. See Ebke & Griffin, *supra* note 1, at 795-98. In the seminal Texas case of *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984) (writ dismissed by agreement), neither the parties nor the court relied upon the doctrine of good faith and fair dealing. For a thorough analysis of *Farah*, see Ebke & Griffin, *supra* note 1, at 777-91.

4. See generally Ailts, *A New Tort for Texas: Breach of the Duty of Good Faith and Fair Dealing*, 18 ST. MARY'S L.J. 1295 (1987); Hubble, *Survey: Good Faith and Fair Dealing: An Analysis of Recent Cases*, 48 MONT. L. REV. 193 (1987); Comment, *A Proposed New Tort Cause of Action in Missouri for Breach of the Implied Covenant of Good Faith and Fair Dealing in Commercial Contracts*, 31 ST. LOUIS U.L.J. 433 (1987).

become increasingly difficult to make.⁵ An unprincipled expansion of the doctrine of good faith and fair dealing will confuse rather than clarify that distinction.

This Article discusses selected court decisions imposing civil liability for breach of the obligation of good faith and fair dealing and analyzes the question of to what extent, if any, the holdings of these cases may affect commercial lending transactions. Although the principles of contract and tort causes of action for breach of the obligation of good faith and fair dealing are generally well settled today, it is often difficult in lender liability cases to determine the type of action that is brought.⁶ The difficulties result from the possibility that acts of a party may breach duties in either tort or contract alone or simultaneously in both.⁷ The problem is aggravated by the tendency of courts in lender liability cases to use the terms "covenant of good faith" and "duty of good faith" interchangeably. This practice explains, at least in part, the confusion surrounding a lender's liability to its borrower for breach of the obligation of good faith and fair dealing. Throughout this Article, the term "covenant" of good faith and fair dealing will refer to the express or implied contractual obligation of good faith and fair dealing, whereas the term "duty" of good faith and fair dealing will be used to refer to the non-contractual obligation of good faith and fair dealing which is imposed by law irrespective of the existence of a contractual relationship.

The first Part of this Article explores the various contractual bases of lender liability under the good faith doctrine. The application and limitations of lender liability under the tort law duty of good faith and fair dealing are presented in the second Part. In this context, an attempt is made to articulate operational standards that distinguish good faith and fair dealing from bad faith and unfair dealing in commercial lending transactions. In the third Part, attention is drawn to the legal, economical, and social expedience of the emerging theories of lender liability for breach of the obligation of good faith and fair dealing. Throughout, this Article emphasizes the theoretical aspects as well as the practical implications of the obligation of good faith and fair dealing in commercial lending transactions.

I. COVENANT

The contractual obligation of good faith and fair dealing in all commercial lending transactions may arise in one of two forms. The obligation may be expressly stipulated by the parties, or it may be implied in the contract.

A. *Express Covenant*

Commercial lending transactions typically are based upon written contracts that are carefully drafted by legal counsel. These contracts very often contain a covenant that expressly subjects the parties to an obligation of good faith and fair dealing in the performance or enforcement of the contract. The express covenant of good faith and

5. W. PROSSER & W. KEETON, LAW OF TORTS § 92, at 655 (5th ed. 1984).

6. See *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617, 617 (Tex. 1986).

7. *Id.* at 618 (suggesting that the "nature of the injury" most often determines which duty or duties are breached).

fair dealing, when breached, gives rise to an action in contract and enables recovery for compensatory damages.

The effect of the express covenant of good faith and fair dealing in commercial lending transactions is to require that, in their performance or enforcement of the transaction, the parties show good faith in the carrying out of what is expressed in the contract or hoped for, but not expressly regulated, by the parties. The covenant of good faith requires the cooperation of one party to the lending agreement where it is necessary in order that the other party might secure the expected benefits of the bargain.⁸ In the performance of a commercial lending transaction or the enforcement of a right arising out of a loan agreement, a party who evades "the spirit of the agreement" and so denies the other the benefit of the bargain commits a breach even if the evasive conduct is within the letter of the agreement.⁹

The expansive nature of the good faith covenant may lead to results which would have been considered ludicrous in an earlier time. Consider, for example, the terms of a loan agreement under which a lender is required to advance funds to its borrower so long as the borrower maintains certain financial ratios. The language of the loan agreement is clear, and the standard of performance is objective. If a borrower does not satisfy the ratios and thereafter files suit against the lender as a result of the lender's refusal to advance funds, until recently most courts would have had no problem holding in favor of the lender. Yet, the modern trend, at least in some jurisdictions, is to reject such "time honored formalities." Under a broad interpretation of the good faith covenant, a lender must act within the spirit of the agreement, notwithstanding the express terms of the agreement itself. Thus, for instance, a lender may be required to advance money at a time when, under the terms of the written agreement with its borrower, it is technically not required to do so.

B. *Implied Covenant*

In the absence of an express covenant of good faith and fair dealing, the question arises whether an implied contractual obligation of good faith and fair dealing exists in commercial lending transactions.

1. *Uniform Commercial Code*

The answer to this question is relatively simple with respect to transactions that are subject to the Uniform Commercial Code (U.C.C. or Code). Section 1-203 of the U.C.C. states in unambiguous terms that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."¹⁰ The Uniform Commercial Code defines "good faith" in section 1-201(19) as "honesty in fact in the conduct or transaction concerned."¹¹ Thus, contracts within the Code are,

8. See Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 672 (1963).

9. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 234 (1968).

10. U.C.C. § 1-203 (1977).

11. U.C.C. § 1-201(19) (1977).

as a matter of statutory law, subject to an implied contractual obligation of good faith in their performance or enforcement. The premise of good faith within the meaning of section 1-203 of the U.C.C. is that each party to a Code contract will make efforts, honest in fact, to meet the terms and, more importantly, the spirit of the performance and enforcement obligations where the agreement is silent.¹²

Reliance, direct or indirect, on the good faith provisions of the U.C.C. must be made with care and with an eye toward the operational purpose of each article. For example, Article 2 of the U.C.C. applies directly only to contracts for the sale of goods or future goods.¹³ Typical commercial lending transactions such as loans are not contracts for the sale of goods; they are, therefore, not within the ambit of the good faith provisions of Article 2 of the Code. Section 1-208 opens the door, however, for a great number of loan agreements to fall within the Code's good faith provisions. As applied to commercial lending transactions, section 1-208 in effect states that where a lender has the power to "accelerate payment or performance or require collateral or additional collateral 'at will' or 'when he deems himself insecure' . . . he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired."¹⁴ Accordingly, acceleration of a debt triggers the good faith provisions of the Code.

Section 1-208 of the U.C.C., by its very terms, applies to the acceleration of a debt not yet due. Accelerations of debts not yet due may take several forms. Thus, for example, a lender must not declare a promissory note due unless it believes in good faith that the prospect of payment on the note is impaired. A setoff by the lender against the borrower's deposits with the lender may amount to an impermissible acceleration if there is no evidence that the debtor is insolvent.¹⁵ Similarly, a demand for additional collateral or the premature proceeding against the collateral may constitute an acceleration in violation of section 1-208. As previously stated, the term "good faith" is defined in the Uniform Commercial Code as "honesty in fact in the conduct or transaction concerned."¹⁶ This definition establishes a standard of good faith conduct that is less stringent than commercial reasonableness and fair dealing, which Article 2 of the Uniform Commercial Code requires of merchants.¹⁷ The "honesty in fact" standard would also seem to be more subjective than the commercial reasonableness and fair dealing standard.¹⁸ In terms of insecurity, a lender acts in good faith if it acts on what it honestly believes, whether or not that

12. *Rigby Corp. v. Boatmen's Bank and Trust Co.*, 713 S.W.2d 517, 528 (Mo. Ct. App. 1986).

13. See U.C.C. § 2-102 (1977). For an analysis of the applicability of the good faith provisions of the U.C.C. to commercial lending transactions, see Ebke, *Verhaltenspflichten der Kreditinstitute gegenüber sanierungsbedürftigen Kunden nach US-amerikanischem Recht*, 33 RECHT DER INTERNATIONALEN WIRTSCHAFT 329, 332 (1987).

14. U.C.C. § 1-208 (1977). The burden of establishing lack of good faith is on the borrower. *Id.*

15. See *Rigby*, 713 S.W.2d at 530.

16. U.C.C. § 1-201(19) (1977).

17. See U.C.C. § 2-103(1)(b) (1977). For a detailed discussion of the development of the standard of "commercial reasonableness and fair dealing," see Winship, *Jurisprudence and the Uniform Commercial Code: A "Commote,"* 31 Sw. L.J. 843, 856 (1977).

18. *Rigby*, 713 S.W.2d at 533 (citing various sources). *Accord* Bahls, *supra* note 2, at 247 (suggesting that "[t]he honesty in fact standard is a subjective standard . . ."). *But see* *Karner v. Willis*, 238 Kan. 246, 250, 710 P.2d 21, 24 (1985) (Herd, J., dissenting).

belief is actual.¹⁹ Thus, under sections 1-208 and 1-201(19), it is sufficient that the lender honestly believes that the payment of the debt is impaired. To act with honesty in fact is to act without arbitrary purpose. That is to say that the belief of insecurity which prompts the acceleration may not be bereft of rational basis nor amount to an open abuse of that discretionary power.

Considerable confusion exists as to whether a lender's failure to act in good faith in cases governed by the Uniform Commercial Code constitutes a breach of contract resulting in contract damages or an independent tort resulting in tort damages and possibly punitive damages. The Texas Supreme Court has repeatedly held that a lender's breach of the implied covenant of good faith under the Uniform Commercial Code gives rise to a cause of action which sounds in contract.²⁰ The Supreme Court of Montana, by contrast, found that punitive damages may be awarded when the duty of good faith exists as a matter of law rather than as part of the contract itself.²¹ Consequently, the court awarded punitive damages although the loan agreement expressly precluded punitive damages. The court's holding is subject to substantial criticism because section 1-106 of the Uniform Commercial Code expressly prohibits the imposition of any punitive remedy.²² In light of section 1-106, it would seem to be fair to conclude that where the Uniform Commercial Code imposes an obligation of good faith and fair dealing on the parties to a contract or agreement within the ambit of the Code, the breach of that obligation should give rise to contract damages only.

2. Analogy

Even where the Uniform Commercial Code does not apply directly, courts have had little theoretical difficulty imposing upon lenders an obligation of good faith and fair dealing. In some cases, the Uniform Commercial Code has been cited in support of the proposition that lenders have an obligation to perform or enforce the loan agreement in good faith. Thus, for example, in *K.M.C. Co. v. Irving Trust Co.*,²³ the Sixth Circuit relied, in part, upon section 2-309 of the Code to hold a lender liable for failing to notify its borrower prior to a refusal to lend.²⁴ While it is true that section 2-309 requires a party who intends to terminate a contract to give the other party reasonable notice of its intent, the court failed to mention that Article 2 of the Uniform Commercial Code did not apply directly to the loan agreement in question. Consequently, the court did not discuss the intriguing question of whether the good faith provisions of the Uniform Commercial Code can be applied to loan agreements

19. *Rigby*, 713 S.W.2d at 533.

20. *See, e.g.*, *International Bank, N.A. v. Morales*, 736 S.W.2d 622, 624 (Tex. 1987); *Texas Nat'l Bank v. Karnes*, 717 S.W.2d 901, 903 (Tex. 1986) (citing two other cases).

21. *First Nat'l Bank v. Twombly*, 213 Mont. 66, 73, 689 P.2d 1226, 1230 (1984).

22. *See Ebke & Griffin, supra* note 1, at 797 n.134.

23. 757 F.2d 752 (6th Cir. 1985). The case is discussed in Note, *K.M.C. Co. v. Irving Trust Co.* (757 F.2d 752): *Discretionary Financing and the Implied Duty of Good Faith*, 81 Nw. U.L. Rev. 539 (1987). *See also Tyler, supra* note 2, at 416-19; *Ebke & Griffin, supra* note 1, at 796-97.

24. *K.M.C.*, 757 F.2d at 759-60.

by means of analogy.²⁵ One would hope that those courts that are willing to apply the good faith provisions of the Uniform Commercial Code to loan agreements by means of analogy see themselves bound by section 1-106 of the Uniform Commercial Code, according to which remedies under the Code are strictly compensatory in nature.

3. Common Law

Outside the Uniform Commercial Code, the trend in modern American contract law is clearly toward a broader application of the doctrine of good faith and fair dealing. Many American jurisdictions now recognize, as a matter of common law, an implied obligation to perform or enforce a contract in good faith.²⁶ Thus, even in the absence of an express covenant of good faith and fair dealing, any conduct of any party in violation of the implied obligation may result in liability for damages caused by the conduct. The Restatement (Second) of Contracts reflects this view. According to section 205 of the Restatement, "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."²⁷ The Restatement even provides some examples of conduct constituting bad faith, including "evasion of the spirit of the bargain, lack of diligence and slacking off, willing rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."²⁸

A closer look at the case law suggests, however, that in commercial lending cases, the courts of a number of states have declined, outside the Uniform Commercial Code, to hold that every contract contains an implied obligation of good faith and fair dealing. Thus, for example, the Texas Supreme Court, in the case of *English v. Fischer*,²⁹ was unwilling to find an actionable covenant of good faith and fair dealing in all transactions based upon contract.³⁰ The court criticized the good faith doctrine as contrary to the adversarial nature of the legal system. For, according to the court, the good faith theory permits juries to decide cases based upon what might seem "fair and in good faith," rather than upon settled rules of law.³¹ It is at least arguable, however, that the language of the court in *English* is overly broad. The terms of the contract in question expressly authorized the conduct complained of by the party advancing the good faith theory.³² Narrowly read, the case stands for the simple proposition that, under Texas law, the implied covenant of good faith and fair dealing cannot be relied upon to contradict the express, negotiated terms of a

25. See Ebke, *supra* note 13, at 332.

26. For a catalogue of cases, see Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 404 (1980). See also *Seman v. First State Bank*, 394 N.W.2d 557, 560 (Minn. Ct. App. 1986).

27. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

28. *Id.* § 205 comment d.

29. 660 S.W.2d 521 (Tex. 1983). For a detailed discussion of *English*, see Ailts, *supra* note 4, at 1311-17.

30. *English*, 660 S.W.2d at 522.

31. *Id.*

32. *Id.* at 522-23. Although the identity of the drafters of the contract in *English* is not apparent from the reported decision, it is significant that one party to the contract was an attorney and the other party was the ex-wife of an attorney.

contract.³³ This limited interpretation of the case is consistent with subsequent decisions citing but not overruling *English*.³⁴

Whether expressed in a written loan agreement or implied as a matter of law, the covenant of good faith and fair dealing serves as a standard of performance in contractual undertakings. In some jurisdictions the application of the covenant may be limited to those circumstances not otherwise agreed upon by the parties. Other jurisdictions may rule that the covenant confers a judicial license upon the courts to review the relative bargaining positions of the parties and the express terms of the agreement. The real question behind the potentially different views would seem to be the question of how much freedom of contract the legal system is willing to accept in commercial lending transactions. Plaintiffs and defendants should realize that whether or not a court will recognize a common law obligation of good faith and fair dealing in a commercial lending transaction will depend almost entirely upon whether the court is willing to accept the basic notion of freedom of contract³⁵ or views its role as that of a social engineer who can reallocate the bargaining power of the parties with hindsight, thereby furthering its own view of justice.³⁶

II. DUTY

Regardless of its application within any particular jurisdiction, the covenant of good faith and fair dealing is overshadowed by the prospect for enhanced damage awards in tort for breach of the good faith duty. Recently, some courts, including the Texas Supreme Court, have held that, in certain cases, an action may lie in tort for breach of the implied obligation of good faith and fair dealing. Judicial recognition of the implied duty of good faith and fair dealing in contractual relationships results from the search by some courts for a principled basis on which to award punitive damages for breach of contract.³⁷ It is settled today that exemplary damages are not an appropriate remedy for breach of an express or an implied covenant in contract.³⁸ As a general rule, contractual damages should be measured by the benefit expected to be obtained by the non-breaching party. It is well established, however, that punitive damages may be awarded for breach of a duty in tort.³⁹ Punitive damages

33. *Id.* at 522. The concurring opinion lists cases in which, contrary to the majority opinion, Texas courts have recognized an obligation of good faith and fair dealing in contractual relationships. *See id.* at 524.

34. *See, e.g., Exxon Corp. v. Atlantic Richfield Co.*, 678 S.W.2d 944, 947 (Tex. 1984) ("The agreement made by the parties and embodied in the contract itself cannot be varied by an implied good-faith-and-fair-dealing covenant.").

35. The reference to the principle of freedom of contract, of course, is not meant to suggest that lenders are entirely free to impose upon borrowers their own terms in loan agreements regardless of reasonableness.

36. *See Ebke & Griffin, supra* note 1, at 796 n.123.

37. *See generally* 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).

38. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981). *See also Bellefonte Underwriters Ins. Co. v. Brown*, 704 S.W.2d 742, 745 (Tex. 1986); *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 571 (Tex. 1981); *Texas Nat'l Bank v. Karnes*, 717 S.W.2d 901, 903 (Tex. 1986).

39. RESTATEMENT (SECOND) OF TORTS § 908 (1979). *See also International Bank, N.A. v. Morales*, 736 S.W.2d 622, 624 (Tex. 1987) (stressing the significance of "a finding of an independent tort with accompanying actual damages").

provide additional recovery to the victim and arguably deter similar tortious conduct in the future.⁴⁰

The obligation of good faith and fair dealing is the common element linking contract law covenants and tort law duties. At inception, the relationship between borrower and lender is inherently contractual in nature. From the contract, a covenant of good faith and fair dealing may be implied, at least in some jurisdictions, that neither party will "do anything which will injure the right of the other to receive the benefits of the agreement."⁴¹ While the contract is executory as to one or both of the parties, special circumstances may arise which operate to transform the covenant of good faith and fair dealing into a duty of good faith and fair dealing, the breach of which may support an award of exemplary damages.⁴²

A. *Special Circumstances and Relationships*

As a catalyst causing the transformation from contract to tort, special circumstances develop through the relationship between the parties and their conduct toward one another. Courts have almost uniformly required the existence of special circumstances as a basis for remedies in tort for breach of the obligation of good faith and fair dealing. Recognition of special circumstances has been particularly prevalent in insurance⁴³ and employment⁴⁴ contract cases. In these cases, courts have used the duty of good faith and fair dealing to equalize the otherwise unequal bargaining power of the parties to such contracts.

The cause of action for breach of the good faith duty in employment and insurance cases has gained relatively widespread acceptance in recent years. Through those cases, attorneys and judges have gained an understanding of the applications and limitations of the cause of action. *K Mart Corporation v. Ponsock*⁴⁵ provides a ready example of this proposition. In this case, the court considered an employee's

40. For a critical analysis of the deterrence argument advanced by proponents of far-reaching civil liabilities of commercial lenders, see Ebke & Griffin, *supra* note 1, at 806-13.

41. See *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 658, 328 P.2d 198, 200 (1958) (discussing implied obligation of good faith and fair dealing in insurer-insured context).

42. See *Tribby v. Northwestern Bank*, 704 P.2d 409, 419 (Mont. 1985):
We are not holding that every contract or every statutorily imposed obligation, alone, carries with it an implied covenant of good faith and fair dealing, the breach of which permits recovery in tort. We hold only that the District Court, *under these circumstances*, did not err when it instructed the jury to consider recovery under tort principles and, accordingly, punitive damages.
(emphasis added).

43. See, e.g., *Aranda v. Insurance Co. of N. Am.*, 748 S.W.2d 210 (Tex. 1988); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987).

The Texas Supreme Court in *Arnold* wrote: "[w]hile this court has declined to impose an implied *covenant* of good faith and fair dealing in every contract, we have recognized that a duty of good faith and fair dealing may arise as a result of a special relationship between the parties governed or created by a contract." *Id.* at 167.

See also *Rawlings v. Apodaca*, 151 Ariz. 149, 726 P.2d 565 (1986) (tort of bad faith developed as a response to insurance adjustment abuses in third-party liability cases); *Keeton v. Bank of Red Bay*, 466 So. 2d 937, 940 n.1 (Ala. 1985) (Supreme Court of Alabama stated that "[a] tort claim for bad faith breach of contract is not a cognizable cause of action except in the context of a contract of insurance." (citing *Sprowl v. Ward*, 441 So. 2d 898 (Ala. 1983))); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

44. See, e.g., *K Mart Corp. v. Ponsock*, 732 P.2d 1364 (Nev. 1987) (punitive damages awarded for tortious breach of the covenant of good faith and fair dealing in an employment contract).

45. *Id.*

claim for breach of the duty of good faith and fair dealing arising out of an employment contract. The court stated that the employee was dependent upon the employer for a means of livelihood and could therefore expect the employer to act in good faith with respect to the termination of his employment contract shortly before his retirement.⁴⁶ The court also found that contractual damages were inadequate to compensate the employee and to deter similar conduct by other employers.⁴⁷ Accordingly, the court concluded that the employer breached its duty of good faith and fair dealing to the employee and awarded punitive damages.⁴⁸

The court seems to agree that not every breach of the covenant of good faith and fair dealing should support tort law remedies. The court stated, in unambiguous terms, that tort law remedies for breach of the obligation of good faith and fair dealing are available only in rare and exceptional circumstances.⁴⁹ Accordingly, the court carefully limited its decision by stating that “[t]he special relationships of trust between *this employee* and *this employer* under *this contract* under *this kind* of abusive and arbitrary dismissal cries out for relief and for a remedy beyond that traditionally flowing from breach of contract.”⁵⁰

Whether or not the same rationale applies to commercial lending transactions is debatable. As applied to loan contracts, some courts may find a tortious breach of the obligation of good faith and fair dealing when a special relationship exists between the lender and the borrower, when the lender engages in egregious or outrageous conduct toward the borrower, and when contractual damages would be inadequate to compensate the borrower or insufficient to deter the lender and other lenders from similar actions. In any event, the existence of special circumstances or a special relationship between a lender and its borrower is essential to a finding of liability under the duty of good faith and fair dealing. Otherwise, every breach of the obligation of good faith and fair dealing would constitute a tort leading to exemplary damages. The term “special relationship” connotes a course of affairs between a lender and its borrower characterized by trust, confidence, control, and reliance.⁵¹ Commonly, those factors indicate the existence of a fiduciary relationship. For that reason, traditional fiduciary principles may apply by analogy to determine the existence of a special relationship between a lender and its borrower.⁵²

46. *Id.* at 1372 (citing F. TANNENBAUM, A PHILOSOPHY OF LABOR 9 (1951)).

47. *Id.* at 1364.

48. *Id.* at 1373.

49. *Id.* at 1370.

50. *Id.* at 1372 (emphasis added).

51. *Id.* Concerning the relationship between employer and employee in *K Mart*, the court stated: “[a]fter involving itself in a relationship of trust and special reliance between itself and its employee and allowing the employee to rely and depend on continued employment and retirement benefits, the company, to serve its own financial ends, wrongfully and in bad faith, breached the employment agreement.” *Id.*

See also *English v. Fischer*, 660 S.W.2d 521, 524 (Tex. 1984) (Spears, J., concurring). In his concurring opinion in *English*, Justice Spears wrote that the common thread among the cases in which courts have read a duty of good faith and fair dealing into contractual transactions is a special relationship between the parties to the contract. *Id.* “That special relationship,” wrote Justice Spears, “either arises from the element of trust necessary to accomplish the goals of the undertaking, or has been imposed by the courts because of an imbalance of bargaining power.” *Id.*

52. *See Carter Equip. Co. v. John Deere Indus. Equip. Co.*, 681 F.2d 386, 390 (5th Cir. 1982) (citing *Parker v. Lewis Grocery Co.*, 246 Miss. 873, 153 So. 2d 261 (1963), and *Risk v. Risher*, 197 Miss. 155, 19 So. 2d 484 (1944)).

Whether or not a special relationship exists is, of course, a question of fact to be decided by the jury.⁵³ A jury may find that a contractual relationship has given rise to a special relationship if the activity of the lender goes beyond its operating on its own behalf and the activity is for the benefit of both the lender and the borrower.⁵⁴ Similarly, where lender and debtor "have a common interest and profit from the activities of the other," a jury may find a special relationship.⁵⁵ In any case, a jury may find that a special relationship exists only if the parties repose trust or confidence in one another and if the lender has the power to control or dominate the debtor.⁵⁶ The elements of trust, confidence, control, and reliance, it seems, are designed to limit the liability that may arise from the duty of good faith and fair dealing by narrowly defining the parameters of the "special relationship."

B. *The Commercial Cotton Rule*

In light of these requirements, most courts have refused to find a special relationship between a lender and its borrower sufficient to support recovery for a tortious breach of the duty of good faith and fair dealing.⁵⁷ Nevertheless, at least one court has recognized the existence of a special relationship in a case involving a bank. It should be noted, however, that the special relationship was found to exist between a bank and its depositor, not between a bank and its borrower. In *Commercial Cotton Company v. United California Bank*,⁵⁸ a California appellate court stated that the relationship between a bank and its depositor is characterized by elements of public interest, adhesion, and fiduciary responsibility.⁵⁹ The court noted the extensive regulation of the banking industry and the trust reposed in banks by depositors. Based upon those factors, the court concluded that the relationship between a bank and its depositor is a special relationship, justifying tort liability for conduct in violation of the duty of good faith and fair dealing.⁶⁰

Commercial Cotton cannot be cited, however, in support of the general proposition that a lender stands in a fiduciary relation to its borrower. Arguably, the relationship between a bank and its depositor is fiduciary in nature due to the fact that a depositor entrusts its funds to the banking institution, which is obligated to hold the funds for the benefit of the depositor. In a lender-borrower situation, by contrast, a bank entrusts its funds to its borrower, who then in turn uses the funds to further its

53. See *Carter*, 681 F.2d at 390.

54. *Id.* at 391.

55. *Id.* (citing *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979)).

56. *Id.* See also *Jackson Rapid Delivery Serv. v. Jones Truck Lines*, 641 F. Supp. 81, 84 (S.D. Miss. 1986) (enumerating the characteristics of a fiduciary duty arising in contractual relationships); *First Bank v. Moden*, 235 Kan. 260, 262, 681 P.2d 11, 13 (1984) (weakness of age, mental strength, business intelligence, knowledge of the facts involved, or other conditions giving the lender an advantage over the borrower may indicate existence of a fiduciary relationship).

57. See, e.g., *Moden*, 235 Kan. 260, 262, 681 P.2d 11, 13 ("Ordinarily, the relationship between a bank and its customer is that of a creditor-debtor and not that of a fiduciary."). For a more detailed exposition of this view, see *Ebke & Griffin*, *supra* note 1, at 795-98.

58. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) (noted in *Kitada, Emerging Theories of Bank Liability—The Breach of the Covenant of Good Faith and Fair Dealing*, 103 BANKING L.J. 80 (1986)).

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

60. *Id.*

own interests. Although this distinction would seem to be significant, the trend, at least in California, is to impose a duty of good faith and fair dealing in all contractual relationships.⁶¹

C. *Bad Faith and Unfair Dealing*

Assuming that a special relationship exists between a lender and its borrower, damages other than compensatory damages are not available in all cases. Punitive damages may be awarded only for acts or omissions resulting from bad faith and unfair dealing.⁶² Yet, not every breach of the duty of good faith and fair dealing constitutes bad faith and unfair dealing. At a minimum, a finding of bad faith requires conduct by the lender which is clearly arbitrary, malicious, or capricious.⁶³ Some courts have ruled, however, that in order to obtain punitive damages, a plaintiff must prove that the defendant consciously pursued a course of conduct with knowledge that the conduct presented a substantial risk of harm to another.⁶⁴ One court held that punitive damages "are recoverable in bad faith *tort* actions, *when, and only when*, the facts establish that defendant's conduct was aggravated, outrageous, malicious or fraudulent."⁶⁵ In commercial lending transactions, such conduct would seem to be the exception rather than the rule.

III. CONCLUDING OBSERVATIONS

The foregoing discussion of some pertinent cases illustrates that the law of lender liability is in flux. In addition to traditional contract and tort liability theories, courts are developing novel theories to hold lenders liable to their debtors in cases where there would have been no liability a few years ago. The theory of good faith and fair dealing is probably the single most disturbing of all the lender liability theories that are presently evolving.

In light of the nature of the obligation of good faith and fair dealing, it is highly questionable whether the emerging good faith doctrine is likely to promote more desirable conduct on the part of lenders in commercial lending transactions.⁶⁶ The obligation of good faith and fair dealing, by its very nature, provides no objectively identifiable guidelines concerning the bounds of legally permissible conduct. The obligation of good faith and fair dealing does no more than instruct the lender that "it is right to do right." In commercial lending transactions, such a mandate is, without further delineation, formless and inconsistent with the basic notion of fairness that notice be given as to what activities are legally permitted or prohibited.⁶⁷ If the

61. See, e.g., *Seaman's Direct Buying Serv. v. Standard Oil Co. of Cal.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

62. See generally Comment, *Damages Measurement for Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161 (1986).

63. See, e.g., *Noonan v. First Bank Butte*, 740 P.2d 631, 635 (Mont. 1987).

64. See, e.g., *Rawlings v. Apodaca*, 151 Ariz. 149, 162, 726 P.2d 565, 578 (1986).

65. *Id.* (emphasis added).

66. For a more detailed exposition of this view, see Ebke & Griffin, *supra* note 1, at 798, 806-13.

67. For example, in *Chiarella v. United States*, 445 U.S. 222 (1980), the Supreme Court stated that "a judicial holding that certain undefined activities 'generally are prohibited' . . . would raise questions whether either criminal or

objective of the emerging theories of lender liability is to promote fairness and certainty in commercial lending transactions, and the authors believe it is, the actionable obligation of good faith and fair dealing is presently too broad and amorphous to serve as a basis of lender liability, as no workable limits to liability exist. Judicial interpretations thus far have not provided clear boundaries of acceptable conduct. A case-by-case approach, while appropriate for a remedial sanction such as an injunction, is not appropriate for the remedy of damages.

What is even more disturbing is the gradual erosion by the judiciary of the distinction between the covenant and the duty of good faith and fair dealing. This development opens the door for extraordinary exemplary damage awards, possibly even in the absence of clearly arbitrary, malicious, or capricious conduct. Much has been written on the question of whether the present tort law system with its compensatory and exemplary damage awards effectively serves deterrence and prevention purposes.⁶⁸ With respect to commercial lending transactions, the authors of this Article have come to the conclusion that, in light of all available evidence, the evolving lender liability theories in general and the increasing threat of liability for punitive damages in particular add very little in terms of deterrence and prevention.⁶⁹ Yet, even if one assumes that the emerging theory of good faith and fair dealing can be justified on the ground that it prevents economic harm by deterring unreasonable conduct on the part of commercial lenders, punitive damage awards for a lender's breach of the obligation of good faith and fair dealing would seem to be improper where the conduct of the lender is not clearly arbitrary, malicious, or capricious. This is so because the standards of conduct in the commercial lending area remain relatively uncertain.⁷⁰

In this context, it should be noted that the United States Supreme Court has agreed to consider whether punitive damage awards constitute excessive fines or violate the due process mandates of the United States Constitution when juries have no guidelines as to when punitive damages should be awarded and when no limits exist as to the amount that may be assessed.⁷¹ Although the case before the Court does not involve any of the developing theories of lender liability, the decision may have a stabilizing impact on this unsettled area of law. If the Court finds that punitive damages, excessive or otherwise, violate the Constitution, lenders, it seems, would have a strong case for the proposition that they should not be held liable for punitive damages if they adhere to the terms of the lending agreements with their borrowers.

Civil liability of commercial lenders to their borrowers, it has been said, is part

civil defendants would be given fair notice that they have engaged in illegal activity." *Id.* at 235 n.20 (emphasis added). While *Chiarella* involved an alleged criminal violation of § 10(b) of the Securities Exchange Act of 1934, the Supreme Court expressly referred to civil defendants. *Id.*

68. For excellent theoretical analyses of this question, see Fleming, *Is There a Future for Tort?*, 44 LA. L. REV. 1193 (1984), and Sugarman, *Doing Away with Tort Law*, 73 CALIF. L. REV. 555 (1985).

69. Ebke & Griffin, *supra* note 1, at 811.

70. *Accord* Case Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161, 1187-89, 1197-98 (1985) (punitive damage awards improper in commercial setting when standards of conduct uncertain).

71. *Kelco Disposal, Inc. v. Browning-Ferris Indus., Inc.*, 845 F.2d 404 (2d Cir.), *cert. granted*, 57 U.S.L.W. 3394 (1988). See also *Supreme Court Shows Interest in Debate on Limiting Damage Awards in Civil Suits*, Wall St. J., Jan. 5, 1988, at 27, col. 6.

of a net of control devices that the legal system has developed in order to strengthen the integrity of the banking system for the benefit of both individuals and the public.⁷² Assuming that this observation is correct, for the sake of the balance of the system when taken as a whole, none of the control devices should be overemphasized at the expense of the others. The trend today, no doubt, is clearly toward an expansion of civil liabilities of lenders rather than the utilization of other measures of control. The evolving liability theory of good faith and fair dealing epitomizes this development. Legal theories of lender liability are emerging so rapidly that lawyers do not have time to react; instead, lawyers in their respective capacities as judges, legislators, attorneys, administrators, and academicians must now exercise analytical ingenuity and engage in creative imagination to be able to cope with the problem of how the position of lenders vis-a-vis debtors can be preserved without violations of the debtors' interests.

In this regard, the enormous transactional costs that are associated with the expansion of civil liabilities of commercial lenders deserve special attention.⁷³ These costs are particularly high with respect to the evolving liability theory of good faith and fair dealing as, under this theory, the number of fact questions to be resolved between opposing parties will be increased.⁷⁴ The result, of course, is an increase in the cost of litigation as the possibility of summary judgment is reduced. The legal, economic, and social effects of the increasing cost of litigating commercial lending cases is a significant factor yet to be studied carefully. Some banking lawyers have predicted that an expansion of the liability of lenders will result in defensive lending practices.⁷⁵ It will be particularly interesting to see whether these predictions come true.

Whether or not one views the emerging theory of lender liability for breach of the obligation of good faith and fair dealing as beneficial, it should be remembered that an overexpansion of lender liability theories, irrespective of how noble the judiciary's motives may be, is more likely to upset the present balance between the adverse interests of lenders and borrowers than attempts to proceed cautiously toward a rational body of principles and rules of lender liability.⁷⁶ In their endeavor to shape lender liability law, courts should closely coordinate existing and emerging liability theories so as to create a body of coherent principles and rules that give commercial lenders fair notice that certain activities are unacceptable, regardless of express terms of contract, and may result in liability for damages. Those rules should provide courts, attorneys, borrowers, lenders, and all concerned with adequate guidance as to whether and how a lender's conduct resulting in economic harm to a debtor can be remedied. In any event, borrowers, lenders, and society will be decidedly better off if the boundaries of the lender liability theories generally and the doctrine of good faith and fair dealing specifically are not unreasonably or unwisely expanded.

72. Ebke & Griffin, *supra* note 1, at 806.

73. For details, see Ebke & Griffin, *supra* note 1, at 811-13. See also Note, *The Growth of Lender Liability: An Economic Perspective*, 21 GA. L. REV. 723 (1987).

74. See *supra* text accompanying note 53.

75. See Bailey, *Banks Hit by Borrowers' Liability Suits*, Wall St. J., June 2, 1988, at 25, col. 3.

76. For a more detailed exposition of this view, see Ebke & Griffin, *supra* note 1, at 800-17.

