Volume 92
Issue 2 *Dickinson Law Review - Volume 92, 1987-1988*

1-1-1988

Lender Liability for Negligently Processing Loan Applications

Nan S. Ellis

John A. Gray

Lender Liability for Negligently Processing Loan Applications

Nan S. Ellis and John A. Gray*

I. Introduction

Purchasing a home is the single most important investment in most people's lives. When a person applies for a mortgage and pays the required loan application fee, he expects the lender to process the application carefully. If, instead, the lender fails to process the application in accordance with standard banking practices and the loan is denied, the applicant might be forced to seek alternative financing. If, while the lender processes the initial loan application, interest rates rise dramatically, the costs of the alternative financing could be substantially more than the costs had the initial application been approved. The applicant would be understandably angry. Would he or she, however, have any legal recourse against the lender?

In a case of first impression nationally, *Jacques v. First National Bank of Maryland*,[1] a unanimous court granted relief to residential mortgage loan applicants who had been forced to obtain more expensive alternative financing due to the careless denial of their application by the first lender. The *Jacques* court held that the lender bank had a duty to exercise reasonable care in the processing of the mortgage loan application.

To the average person, the outcome probably appears obvious and certainly not shocking. Anyone who applies for a loan assumes that the lender will consider the application with reasonable care and will grant the loan to qualified applicants. It might seem reasonable to require the lender to compensate the loan applicant for a mistake in determining loan eligibility which causes damages in the form of higher alternative financing costs. To the banking industry, however, the potential for liability created by this decision is enormous. Given the number of residential mortgage transactions processed daily na-

* Nan S. Ellis is an Associate Professor of Law at the Sellinger School of Business and Management, Loyola College, Maryland. John A. Gray is an Associate Professor of Law at the Sellinger School of Business and Management.

1. 307 Md. 527, 515 A.2d 756 (1986). While lender liability has been an explosive area in recent years, *see infra* notes 3-7 and accompanying text, this is the first case to create liability for failure to lend money due to negligent processing of the loan application.

tionwide, the widespread impact of this decision is self-evident. The impact upon both lender and applicant could be even more substantial since the *Jacques* rationale may be extended to any loan transaction.[2]

Although lenders have been found liable[3] to borrowers[4] and third parties[5] with increasing frequency under so-called lender liability theories,[6] no prior case extended the concept of lender liability to create a duty to process a loan application with due care. The purpose of this article is threefold. First, it will outline the common law treatment of lender liability, specifically the application of both tort and contract principles to lender liability actions. Second, the article will examine the *Jacques* case. Since *Jacques* imposed tort liability upon the defendant stemming from a contractual relationship, the interrelationship between tort and contract law also will be explored. In particular, the rationale of *Jacques* will be analyzed in light of

2. Although *Jacques* addressed a residential mortgage loan, its reasoning may be applicable to any type of loan to any loan customer by any lending institution. *See infra* note 143 and accompanying text.

3. Several cases illustrate the severity of the risk of liability to lenders. In the landmark case of State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. App. 1984), the court awarded over $18 million to the plaintiffs upon, among other grounds, fraud, duress and interference with corporate governance. In K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985), the court awarded $7.5 million for breach of the implied contractual obligation of good faith and fair dealing. Recently, a federal district court in Maine awarded plaintiffs $15 million for intentional infliction of emotional distress, breach of contract, and violations of the Equal Credit Opportunity Act. Ricci v. Key Bancshares, Inc., 768 F.2d 456 (1st Cir. 1985). Perhaps the best example of the risk to banks is the recent case of Scharenberg v. Continental Illinois Nat'l Bank, 87-00238-CIV-DAVIS. In this case, the court awarded plaintiffs $105 million for breach of contract after the bank refused to extend credit as promised.

4. *See, e.g.*, Flick and Replansky, *Liability of Banks to Their Borrowers: Pitfalls and Protections*, 103 BANKING L.J. 220 (1986).

5. The third parties have included the trustee in bankruptcy, third party creditors, shareholders, and the government.

6. The term "lender liability" applies to situations in which liability is imposed upon a lender for its conduct with respect to a loan. For commentary discussing the developing area of lender liability, see Burcat, *Environmental Liability of Creditors: Open Season on Banks, Creditors, and Other Deep Pockets*, 103 BANKING L.J. 509 (1986); Chaitman, *The Ten Commandments for Avoiding Lender Liability*, SECURED LENDER 10 (November 1986); Cohen, *Hazardous Waste: A Threat to the Lender's Environment*, 19 U.C.C. L.J. 99 (1986); Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975); Ebke and Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775 (1986); Lundgren, *Liability of a Creditor in a Control Relationship with its Debtor*, 67 MARQ. L. REV. 523 (1984); Malloy, *Lender Liability for Negligent Real Estate Appraisals*, 1984 U. ILL. L. REV. 53 (1984); Weissman, *Lender Liability: The Obligation to Act in Good Faith and Deal Fairly*, J. COM. LENDING 2 (Dec. 1986).

The theories upon which such liability is imposed are unclear and varied. Certain similarities, however, seem to prevail among court decisions attaching liability. Creditor control over the affairs of the debtor, *see infra* notes 7, 8, and 32 and accompanying text, and creditor bad faith, *see infra* notes 26-34 and accompanying text, are often cited as prerequisites to lender liability.

two questions: Is a loan application merely a request to do business, or is it a contract once it is accepted for processing? Further, it if *is* a contract, should it create a concomitant tort duty of care on the part of the lender? The article concludes that any loan application, once accepted, should be recognized as a contract but that a concomitant tort duty of care is only created in a consumer lending situation. This article also contends that the *Jacques* court failed to adequately address the basic differences between contract and tort. Finally, the article discusses the practical implications for lending institutions resulting from the *Jacques* holding.

II. The Common Law of Lender Liability

Since the *Jacques* decision is a significant development in the law of lender liability, it is initially useful to briefly outline that developing area of the law. Common law lender liability[7] is based upon either tort or contract.

A. Tort-Based Liability

Plaintiffs have successfully imposed lender liability on the basis of such tort theories[8] as fraud,[9] duress,[10] interference with business

7. The cases can be divided into two basic categories: those asserting liability based upon common law principles, and those asserting liability based upon statutory principles. Liability has been imposed upon lenders under numerous statutes. For example, the provisions of state Uniform Fraudulent Conveyances Acts have been applied to lenders. *See, e.g.*, United States v. Gleneagles Inv. Co., Inc., 565 F. Supp. 556 (M.D. Pa. 1983), *aff'd* United States v. Tabor Court Realty Corp., 803 F.2d 1289 (3d Cir. 1986). Lender control can be evidence of lack of good faith relevant to a determination of fair consideration. *See, e.g.*, In re Lumber Co., 5 Bankr. 470 (D. Minn. 1980). This can result in avoidance of a transfer to the lender under state acts or in an avoidance of the lender's claims under the Federal Bankruptcy Act, should the debtor file bankruptcy. *See, e.g.*, Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980). *See generally*, Alden, Gross and Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem*, 38 BUS. LAW. 605 (1983); Coppel and Kann, *Defanging Durrett: The Established Law of "Transfer"*, 100 BANKING L.J. 676 (1983). Similarly, lenders have found their claims defeated in bankruptcy under grounds of equitable subordination. 11 U.S.C. § 510(c) (1982). *See, e.g.*, Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561 (1984). In addition, liability has been successfully asserted against lenders based upon violations of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1961, *et seq.* (1982). *See, e.g.*, Norman v. Itex Corp., No. 84-C-421 (E.D. Ill. Aug. 21, 1986), *cited in* ABA IV *Emerging Theories of Lender Liability* (1987); Securities Acts, and the Internal Revenue Code. I.R.C. §§ 3505(a) and (b) (1982). *See generally* Lundgren, *supra* note 6, at 546-49. Finally, an area of increasing liability for lenders is the area of hazardous waste disposal. *See generally* Cohen, *Hazardous Waste: A Threat to the Lender's Environment*, 19 U.C.C. L.J. 99 (1986).

8. It should be noted that cases imposing tort liability generally utilize traditional tort theories. The prima facie tort is an exception to this generalization. Under this theory, a plaintiff recovers when he is injured by an otherwise lawful action that is committed intentionally. The elements of this tort are: 1) an intentional act committed by the defendant; 2) injury to the plaintiff; 3) intent to injure; and 4) absence of sufficient justification. *See, e.g.*, Porter v. Crawford & Co., 611 S.W.2d 265 (Mo. App. 1980). *But see* Luxonomy Cars, Inc. v. Citibank,

relations,[11] and negligent misrepresentation.[12] In addition, plaintiffs have attempted, unsuccessfully for the most part, to assert liability based upon breach of fiduciary duties.[13]

Plaintiffs have also asserted claims against lenders upon negligence grounds, charging both negligent lending and negligent administration of loans. While these claims have been, by and large, unsuccessful,[14] they provide a useful framework within which to examine the *Jacques* decision.

Courts appear to be unwilling to attach liability to a lender for negligently lending money, absent active participation "in the fi-

---

65 A.D.2d 549, 408 N.Y.S.2d 951 (1978). The *Jacques* plaintiffs asserted the prima facie tort as a basis for liability, but they later dismissed the cause of action voluntarily. Thus, the issue was not discussed by either appellate court.

Although the theories are standard, their application to the facts is unique. In most cases, courts place substantial emphasis on the control the lender exerts over the borrower. For example, in State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. App. 1984), the loan documentation contained a management change clause which provided that any change in the borrower's management that the lender believed adverse to its interests constituted a default. *See generally* Lundgren, *supra* note 6. *See also* Ebke and Griffin, *supra* note 6, at 791-95; Schechter, *The Principal Principle: Controlling Creditors Should be Held Liable for Their Debtor's Obligations*, 19 U.C. DAVIS L. REV. 875 (1986).

9. *See, e.g.*, Stirling v. Chemical Bank, 382 F. Supp. 1146 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. App. 1984).

10. *See, e.g.*, State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. App. 1984).

11. *Id.*

12. *See, e.g.*, Berkline Corp. v. Bank of Mississippi, 453 So.2d 699 (Miss. 1984).

13. As a general rule, lenders do not owe fiduciary duties to their borrowers. *See, e.g.*, In re W.T. Grant Co., 4 Bankr. 53 (S.D.N.Y. 1980), *aff'd* 699 F.2d 599 (2d Cir. 1983); Washington Steel Corp. v. TW Corp., 602 F.2d 594 (3d Cir. 1979). *See generally* Note, *Bank Financing of Involuntary Takeovers of Corporate Customers: A Breach of a Fiduciary Duty?*, 53 NOTRE DAME L. REV. 827 (1978) [hereinafter Note, *Bank Financing*]; Annot., 70 A.L.R.3d 1344 (1976). It seems evident that with respect to loan negotiation and work-out, the relationship between the lender and the borrower is more arms-length than fiduciary. Certain exceptions, however, merit notation. Banks owe a fiduciary duty to their depositors to disclose certain information. *See, e.g.*, Commercial Cotton Co. v. United California Bank, 163 Cal. App.3d 511, 209 Cal. Rptr. 551 (1985). *See also* Barrett v. Bank of America, 178 Cal. App.3d 960, ___ Cal. Rptr. ___ (1986) (fiduciary relationship gives rise to a duty on the part of the bank to disclose to its borrower any facts which would give the bank an advantage). Banks are also under a fiduciary duty to preserve the confidentiality of information included on a loan application. *See, e.g.*, Djowharzadeh v. City Nat'l Bank & Trust Co., 646 P.2d 616, 619 (Okla. App. 1982). This duty also requires that the bank refrain from use of such confidential information to aid one customer in a takeover attempt of another customer. *See, e.g.*, American Medicorp, Inc. v. Continental Ill. Nat'l Bank and Trust Co., 475 F. Supp. 5 (N.D. Ill. 1977); Humana, Inc. v. American Medicorp, Inc., 1977-78 FED. SEC. L. REP. (CCH) Para. 96,286 at 92,827 (court refused to find a *per se* violation merely because the bank financed customer #2's take-over attempt of customer #1 while in possession of confidential information furnished by customer #1).

14. See *infra* notes 15-25 and accompanying text. For discussion of a related issue, see Comment, *Is the Account Good For This Check? Bank Liability for Negligent Responses to Credit Inquiries*, ANN. REV. BANKING L. 165 (1983), in which the author discusses bank liability to third parties stemming from negligent treatment of credit inquiries.

nanced enterprise beyond the domain of the usual money lender."[15] In *Gries v. First Wisconsin National Bank*,[16] plaintiff-borrowers sued the bank, alleging that the bank was negligent in lending them money to establish a retail business which subsequently failed. The court rejected plaintiffs' theory. Although the discussion focused more upon whether the standard of care[17] was breached,[18] the court found that the lender owed no duty of care[19] to the borrowers. The fact that there was no lender control or participation in the debtor's business enterprise might have been crucial in reaching this conclusion.[20]

In *Wagner v. Benson*,[21] the court again refused to hold the defendant-lender liable for negligence in loaning the plaintiff money. The court cited the absence of lender control as a crucial factor in determination.[22] The only court which had imposed tort liability for negligent lending was *Connor v. Great Western Savings and Loan*.[23] In *Connor*, the presence of lender participation in the development plan subjected the lender to liability for the borrower's purchase of defectively designed and built residential units.[24] In addition to the courts' reluctance to impose liability for negligently lending money absent participation in the financed enterprise, courts appear to be equally unwilling to impose liability for negligent administration of a loan without lender control over the disbursement of the funds.[25]

---

15. Wagner v. Benson, 101 Cal. App. 3d 27, 35, 161 Cal. Rptr. 516, 521 (1980), *quoting* Conner v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 864, 447 P.2d 609, 616, 73 Cal. Rptr. 369, 376 (1968).

16. 82 Wis. 2d 774, 264 N.W.2d 254 (1978).

17. The standard asserted by the plaintiff would require the lender to "exercise that degree of care and skill which an ordinarily prudent financial institution would exercise under the circumstances." *Id.* at 777, 264 N.W.2d at 256.

18. The court held that merely because other financial institutions had denied the loan and plaintiffs had little business experience did not establish breach of this standard. *Id.* at 779, 264 N.W.2d at 257.

19. See *infra* note 78 and accompanying text for a discussion of the elements necessary to sustain a prima facie case of negligence.

20. Gries v. First Wis. Nat'l Bank, 82 Wis. 2d 774, 780, 264 N.W.2d 254, 257 (1978).

21. 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980).

22. *Id.* at 35, 161 Cal. Rptr. at 521.

23. 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1969).

24. For a discussion of *Connor*, see Comment, *Liability of the Institutional Lender for Structural Defects in New Housing*, 35 U. CHI. L. REV. 739 (1968).

25. *See, e.g.*, Brunswick Bank & Trust Co. v. U.S., 707 F.2d 1355 (Fed. Cir. 1983); Columbia Plaza Corp. v. Security Nat'l Bank, 676 F.2d 780 (D.C. Cir. 1982). In both cases, courts found the bank negligent in its loan administration because of the control exercised over the funds. *See generally* Flick and Replansky, *supra* note 4, at 232-33.

B. Contract-Based Liability

The contract doctrine of good faith and fair dealing[26] also has been applied to impose lender liability. This doctrine requires the lender to act in good faith[27] and to deal fairly with its borrowers.[28] As a common law doctrine, it is implied in all contracts; it is also an implied covenant under the Uniform Commercial Code.[29] Courts have found lenders liable for breach of the obligation of good faith and fair dealing for refusal to honor lending commitments,[30] for refusal to make advances pursuant to an existing agreement,[31] for improper use of loan covenants,[32] for improper acceleration,[33] and for

26. While the claims discussed here arise from the covenant of good faith implied in the contract, some courts have found the lender liable for *tortious* breach of the contract. *See, e.g.*, Alaska Statebank v. FairCo, 674 P.2d 288 (Alaska 1983); Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985); First Nat'l Bank v. Twombley, 689 P.2d 1226 (Mont. 1984). *Contra* Betterton v. First Interstate Bank, 800 F.2d 732 (8th Cir. 1986). This can be likened to the trend imposing liability for bad faith breach of contracts. While most courts have limited this application to bad faith breach of insurance contracts, some have expanded the tort to include other contracts with "similar characteristics." Seaman's Direct Buying Serv. v. Standard Oil Co., 36 Cal. 3d 752, 770, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984). *See generally* Barrett, *"Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510 (1985); Cohen, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CALIF. L. REV. 1291 (1985); Curtis, *Damage Measurements for Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161 (1986); 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).

27. The question, of course, arises as to what constitutes lender good faith. The Uniform Commercial Code defines good faith as "honesty in fact in the conduct or transaction concerned." U.C.C. § 1-201(19) (1978). There is, however, disagreement over what this standard entails. *See generally* Eisenberg, *Good Faith Under the Uniform Commercial Code — A New Look at an Old Problem*, 54 MARQ. L. REV. 1 (1971); Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982). At least one commentator asserts that an objective standard should be imposed to determine good faith in lender liability cases. Weissman, *supra* note 6, at 1.

28. Weissman, *supra* note 6, at 1. *See also* Cohen v. Ratinoff, 147 Cal. App. 3d 321, 195 Cal. Rtpr. 84 (1983).

29. This is both a common law and a statutory theory since the common law concept of good faith and fair dealing applies to all contracts covered by the U.C.C. through § 1-103 and expressly in § 1-203. U.C.C. §§ 1-103; 1-203 (1978). In addition, the good faith requirement explicitly applies to acceleration provisions under the terms of U.C.C. § 1-208. *Id.* at § 1-203. *See also id.* at § 1-208.

30. *See, e.g.*, 999 v. C.I.T. Corp., 776 F.2d 866 (9th Cir. 1985); National Farmers Org., Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984); Sterling Faucet Co. v. First Municipal Leasing Corp., 716 F.2d 543 (8th Cir. 1983).

31. *See, e.g.*, K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985); Yankton Production Credit Ass'n v. Larsen, 219 Neb. 610, 365 N.W.2d 430 (1985).

32. This includes the management change clause in *Farah*, as well as clauses limiting the borrower's right to sell the collateral, *see supra* note 8. *See, e.g.*, Layne v. Fort Carson Nat'l Bank, 655 P.2d 856 (Colo. Ct. App. 1982).

33. *See, e.g.*, Sahadi v. Continental Ill. Nat'l Bank and Trust Co., 706 F.2d 193 (7th Cir. 1983); Brown v. Avemco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979); Universal C.I.T. Credit Corp. v. Shepler, 164 Ind. App. 516, 329 N.E.2d 620 (1975). *But see* Centerre Bank v.

improper foreclosure.[34]

Prior to 1986, the existence of a debtor-creditor relationship had been clearly established in all lender liability cases. The Maryland Court of Appeals, however, recently expanded the area of lender liability in *Jacques v. First National Bank of Maryland*,[35] thus exposing lenders to new risks.

III. *Jacques v. First National Bank of Maryland*

A. The Facts

The Jacques entered into a contract to purchase residential property for $142,000. The agreement provided for a down payment of $30,000 and was contingent on the availability of financing the balance ($112,000) at a rate of no more than 12 ¼% interest. It contained an additional provision obligating the Jacques to increase the amount of their down payment, if necessary, to obtain a loan at the rate stated in the agreement.[36] The agreement also provided for a $10,000 penalty in the event that the Jacques failed to perform. The Jacques submitted a loan application, with a copy of the sales agreement, to First National Bank of Maryland [hereinafter "lender"] for a loan of $112,000. They paid the $144 fee required by the lender to cover the cost of the property appraisal and the credit report. The mortgage rate offered at the time was 11 ⅞%.

After processing, a bank officer informed the Jacques that they qualified for a loan of $74,000. Subsequently, the lender informed them that it had erred in its original determination of their loan eligibility and that they qualified for a loan of no more than $41,400. The Jacques protested and requested an outright refusal, but the lender would not comply.

The Jacques then sought alternate financing. An application similar to the one provided to First National Bank was submitted to another institution. This lender issued a commitment for a thirty year loan in the amount of $100,000. Because of escalating interest costs, the interest rate offered was 13 ⅞%. The Jacques rejected this offer[37] and instead accepted the $41,000 loan offered by First National. They supplemented the $41,400 with personal loans from rel-

---

Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985).

34. *See, e.g.*, Alaska Statebank v. FairCo, 674 P.2d 288 (Alaska 1983).

35. 307 Md. 527, 515 A.2d 756 (1986).

36. *Id.* at 529, 515 A.2d at 757. Theoretically, the down payment obligation could increase from $30,000 to any amount less than $142,000.

37. The sales contract did not require the Jacques to accept financing that exceeded 12 ¼% interest. *Id.* at 530, 515 A.2d at 757.

atives and a short term $50,000 loan from the defendant lender. The short term bank loan required a pledge of their personal stock portfolio and carried a 15% interest rate.

The Jacques then brought suit against the lender on the following grounds: 1) breach of fidelity;[38] 2) prima facie tort;[39] 3) malicious interference with contract; 4) gross negligence; and 5) negligence. A directed verdict was entered against the plaintiffs on the breach of fidelity count, and the plaintiffs voluntarily dismissed the claim for prima facie tort. The jury returned a verdict in favor of the defendants on the issues of gross negligence and malicious interference with contractual relations, and in favor of the plaintiffs on the negligence count.[40] On appeal, the defendants only raised the issue of negligence.

Although several elements comprise the prima facie case for negligence,[41] the major issue at each appellate level was the lender's duty of care, specifically, whether the defendant-lender owed a duty of reasonable care[42] to the plaintiffs in processing their loan application. The Court of Special Appeals [hereinafter *Jacques I*][43] concluded that it did not; the Court of Appeals [hereinafter *Jacques II*][44] concluded that it did.

---

38. Presumably, this is the same as breach of a fiduciary relationship. *See supra* note 13 and accompanying text.

39. *See supra* note 8 and accompanying text.

40. 307 Md. at 531, 515 A.2d at 757-58. The Jacques originally claimed damages of $92,000. At trial, the jury awarded $10,000, concluding that plaintiffs could have mitigated their damages by, at the very least, forfeiting their $10,000 down payment. The Court of Special Appeals sustained the jury award. The question of the appropriateness of mitigation of damages under these circumstances is currently being appealed. *See* Winchurch, *Banking Decision May Reach Court Again*, 39 Daily Record 1 (Feb. 18, 1987).

41. *See infra* note 78 and accompanying text.

42. If a duty is found, the standard is that of a reasonably prudent banker under similar circumstances. Jacques v. First Nat'l Bank, 307 Md. 527, 542-43, 515 A.2d 756, 764 (1986) (*Jacques II*). The jury concluded that this standard was breached by the lender's behavior in processing the loan application in several respects: 1) the lender averaged only two years of the Jacques' income when three years was common, even though it was aware that the two-year figures substantially distorted the Jacques financial picture because of illness during the period; 2) the lender included payments on the Jacques' current home in the calculation, although this was not standard practice; 3) the lender did not consider income from stock; and 4) the loan officer placed excessive weight on the debt-to-income ratio, rather than balancing that factor with a favorable credit history and substantial net worth. *Id.* at 544 n.7, 515 A.2d at 765 n.7.

43. 62 Md. App. 54, 488 A.2d 210 (1985). Absent a duty of care owing to the plaintiff, it is clear that there can be no liability. *See, e.g.*, Carlotta v. T.R. Stark & Assoc., 57 Md. App. 457, 470 A.2d 838 (1984); Furr v. Spring Grove State Hospital, 53 Md. App. 474, 454 A.2d 414 (1983).

44. 307 Md. 527, 515 A.2d 756 (1986).

B. *The Court of Special Appeals: Jacques I*

The Court of Special Appeals, Maryland's intermediate appellate court, held in a 2-1 decision that the lender did not have a duty to exercise reasonable care in processing the loan application. Each of the three justices submitted an opinion. Because there was no majority opinion, each of the three views will be briefly examined.[45]

The court rejected bank liability on the grounds that imposing a tort duty of care would recognize a duty "in direct conflict with the long established right of a person to refuse to do business with others, for nearly any reason or no reason at all."[46] The opinion relied on earlier case law[47] and the First Restatement of Torts as authority for the privilege to refuse to enter business relations without justification.[48] The Restatement nonetheless recognizes certain exceptions to a person's freedom to select those with whom he will enter into contractual relations.[49] The plaintiffs had contended that a residential mortgage lender ought to be treated like a public utility, one of the recognized exceptions. The court disagreed and recognized that although privately owned mortgage lenders are, like public utilities, highly regulated, they are, unlike public utilities, highly competitive. Thus, there was no reason to find lenders within the public utility exception.[50]

---

45. At this point, two judges (the trial judge and the dissenting Court of Special Appeals justice) held in favor of bank liability and two Court of Special Appeals justices opposed liability (although one was clearly in favor of a law protecting consumers against lender carelessness). The end result was no tort liability and no majority opinion.

46. *Jacques I*, 62 Md. App. at 60, 488 A.2d at 213.

47. In McCarter v. Chamber of Commerce, 126 Md. 131, 94 A. 541 (1915), the Court of Appeals stated: "It is a part of every man's legal rights, that he be left at liberty to refuse business relations with any person whomsoever, whether the refusal rests upon reason, or is the result of whim, caprice, prejudice, or malice." *Id.* at 136, 94 A. at 542-43, *quoting* COOLEY ON TORTS § 278. *See also* Silbert v. Ramsey, 301 Md. 96, 482 A.2d 147 (1984); Cunningham v. A.S. Abell Co., 264 Md. 649, 288 A.2d 157 (1972).

48. *Jacques I*, 62 Md. App. at 60-65, 488 A.2d at 213-15. The court cited the first Restatement of Torts § 762 in support of its proposition:

> One who causes intended or unintended harm to another merely by refusing to enter into a business relation with the other or to continue a business relation terminable at will is not liable for that harm . . . .

RESTATEMENT (FIRST) OF TORTS § 762 (1939). The fact that § 762 was not included in the Restatement (Second) of Torts does not indicate that the provisions of § 762 are no longer the law. *See generally* RESTATEMENT (SECOND) OF TORTS reporter comments (1977). Maryland law clearly follows the Restatement rule. *See, e.g.*, Silbert v. Ramsey, 301 Md. 96, 482 A.2d 147 (1984); Cunningham v. A.S. Abell Co., 264 Md. 649, 288 A.2d 157 (1972).

49. These exceptions are based on the law dealing with public utilities, common carriers, civil rights, antitrust violations, malicious interference with contractual relations, and conspiracy to interfere with contractual relations. RESTATEMENT (SECOND) OF TORTS § 762(a)-(c) (1939).

50. *Jacques I*, 62 Md. App. at 63, 488 A.2d at 214.

The court reasoned that submitting a loan application was nothing more than a request to do business with the lender. Since the lender was free to accept or reject such a request for any reason, it was under no duty to review the request with reasonable care. Where there is a right to refuse to do business regardless of motive or reason, there is no duty to be careful in making that decision. An examination of decisions from other jurisdictions supported the decision in *Jacques I*.[51]

A second justice concurred in the result but would have found for the plaintiffs on the breach of fidelity cause of action if raised on appeal.[52] More importantly, the concurring opinion refused to preclude the possibility of recognizing the existence of a duty of care under certain circumstances.[53]

The dissenting opinion agreed with the view that accepting and processing a loan application does not constitute a contract. The dissent, however, would find a duty of care, relying on the principle that "one who assumes to act, even though gratuitously, may thereby become subject to the duty of acting carefully, if he acts at all."[54] The

51. Several cases cited in *Jacques I* merit discussion. In Washington Steel Corp. v. TW Corp., 602 F.2d 594 (3d Cir. 1979), the Court of Appeals found that a bank had no duty to refrain from loaning money for a hostile takeover bid to acquire one of the bank's other customers. Although the *Washington Steel Corp.* case dealt with the issue of a *fiduciary* duty, it was an indication of the reluctance with which courts impose additional duties upon lenders. Likewise, two state courts refused to impose a duty where a lender refused to loan money to the plaintiff. In Deere v. Short, 378 S.W.2d 496 (Mo. 1964), an equipment manufacturer refused to extend loans to the dealer. The court found no duty to make loans beyond the provisions of the contractual agreement. Similarly, in Farabee-Treadwell Co. v. Union & Planters Bank, 135 Tenn. 208, 186 S.W. 92 (1916), the court held that a bank owed no duty to extend a loan or to continue to do business with a customer.

In a case similar to *Jacques*, the California Court of Appeals held that a bank did not owe a duty to exercise care in approving a loan application. Wagner v. Benson, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980). Some crucial facts do, however, distinguish *Wagner* from *Jacques*. In *Wagner*, the plaintiffs argued that the bank negligently *approved* their loan. The plaintiffs then sought to recover losses that were suffered in the business scheme for which the monies were sought. *See also* Gries v. First Wis. Nat'l Bank, 82 Wis. 2d 774, 264 N.W.2d 254 (1978).

52. The justice stated: "Additionally, I concur in the result because Maryland law does not recognize an action for breach of fidelity by a bank, but neither party raises that issue on appeal. I respectfully suggest that a cause of action for breach of fidelity should exist in Maryland . . . ." *Jacques I*, 62 Md. App. at 65-66, 488 A.2d at 216.

53. The justice stated:

> I do not agree that the case law cited to support the law of duty precludes entirely the possibility of finding such an obligation in an appropriate case . . . . The bank's failure to act in good faith when evaluating the Jacques' financial status, if believed, could have resulted in an injury that would not have occurred if the bank followed its standard practice and refused the loan outright. Rather than denying the loan, the bank acted in bad faith in approving it. By imposing a duty of care on a bank, consumers would be protected from such procedures.

Id. at 65-67, 488 A.2d at 215-16.

54. *Id.* at 69, 488 A.2d at 218.

dissent recognized that this principle, found in the Restatement of Torts,[55] is applicable to personal injury and physical harm situations and not to situations in which there is only economic loss. It nonetheless found this principle persuasive "by analogy."[56]

The *Jacques I* dissent discussed *First Federal Savings and Loan Association of Hamilton v. Caudle*,[57] as an illustration of the application of this principle in the banking context. In *Caudle*, a bank agreed to assist the plaintiffs in obtaining an FHA loan to finance the construction of their home, even though it had no obligation to do so. The bank erroneously informed the Caudles that the FHA had approved the loan. The *Caudle* court found that once the defendant bank voluntarily agreed to assist the plaintiffs, it was required to proceed with due care. The *Jacques I* dissent found this case controlling.[58] In *Jacques*, the lender undertook to process the Jacques' application for a mortgage loan, obtaining the information necessary to process the application. The dissent reasoned that at this point, the lender was required to proceed with due care.[59] Furthermore, the dissent found that acceptance of the mortgage loan application by the lender for processing established a business relationship. This business relationship gave rise to mutual duties: the Jacques were expected to accurately furnish the information requested, and the Bank was expected to evaluate the information fairly and objectively.[60]

---

55. Section 323 provides:

> One who undertakes, gratuitously or for consideration, to render services to another which he should recognize as necessary for the protection of the other's person or things, is subject to liability to the other for physical harm resulting from this failure to exercise reasonable care to perform his undertaking, if
>
> (a) his failure to exercise such care increases the risk of such harm, or
>
> (b) the harm is suffered because of the other's reliance upon the undertaking.

RESTATEMENT (SECOND) OF TORTS § 323 (1977). The Institute expressly offers no opinion as to whether the making of an agreement, contract or gratuitous, without in any way beginning performance, is sufficient to create a duty of care. This distinction between nonfeasance and misfeasance is discussed *infra* notes 87-96 and accompanying text.

56. *Jacques I*, 62 Md. App. 54, 70, 488 A.2d at 28 n.5.

57. 425 So.2d 1050 (Ala. 1983).

58. The particular fact situation under which the duty of care arose in *Caudle* is relevant. The bank in *Caudle* was negligent in wrongly informing the plaintiffs that their loan had been approved. In fact, the bank did not notify the customers of its decision to deny the loan until after their house was completed. This is extremely important given the relevance of reliance in a determination of the duty of care for gratuitous undertakings. *See infra* note 83.

59. *Jacques I*, 62 Md. App. at 71, 488 A.2d at 218.

60. The court stated:

> When the Jacques tendered, and the bank accepted, the mortgage loan application, a business relationship was established. Acceptance of the application for processing clearly indicated the bank's willingness to "deal" with the Jacques

In short, the Court of Special Appeals split over the legal nature of the loan application. It considered processing of the loan application to be the procedure by which the lender determined whether it would do business with the applicant. The court found an exercise of the common law right to refuse to do business.[61] The dissent considered it an extension in the lending context of the common law principle that, where one reasonably relies on a gratuitous performance by another, the other has a duty to perform with reasonable care.[62]

C. *Court of Appeals: Jacques II*

Maryland's highest court, the Court of Appeals, unanimously reversed the Court of Special Appeals and held that a mortgage lender has a tort duty to exercise reasonable care in processing a loan application and in determining loan eligibility. In reaching this conclusion, the court held that a mortgage loan application creates a contract once it is accepted by the lender. Further, public policy requires the lender to exercise reasonable care under the circumstances, because the lender implicitly promises to exercise such reasonable care by virtue of the contract. Accordingly, a person injured by a lender's careless processing of a loan application can elect to sue either in contract or in tort to recover damages.

The court first reviewed the law of negligence recognizing, as the *Jacques I* court had, that the crucial liability issue is whether a duty of care should be imposed. The court stated that whether a duty should arise in a given context must be determined by an examination of the nature of the harm likely to result and the relationship between the parties.[63] Since the nature of the harm was limited to economic loss, a close relationship between the parties was required.[64]

> and gave rise to mutual expectations. First National expected the Jacques to supply information in a timely fashion. The Jacques expected that the information supplied would be fairly, accurately, and objectively evaluated. Both had ultimate expectations as well: First National to realize the profits normally associated with loans of this kind and the Jacques, to obtain a loan at the interest rate committed. These expectations, in turn, gave rise to mutual duties — to act reasonably in their dealings with each other.

Id. at 72, 488 A.2d at 218.

61. Apparently, the court did not consider whether the bank's acceptance and processing of the loan application created a contract.

62. *Id.* at 69, 488 A.2d at 218.

63. *Jacques II*, 307 Md. 527, 534, 515 A.2d 756, 759 (1986).

64. The court stated that "[t]his intimate nexus is satisfied by contractual privity or its equivalent." *Id.* at 534-35, 515 A.2d at 760. The court continued:

> We discern from our review of the development of the law of tort duty that an inverse correlation exists between the nature of the risk on the one hand and

The court concluded that a tort duty of care arises in an economic loss situation[65] only if there is a showing of an "intimate nexus" between the parties, one "satisfied by contractual privity or its equivalent."[66] First, the court evaluated the nature of the relationship between the loan applicant and the lender. Second, it held that if the relationship is contractual in nature, the court must consider the additional factors necessary to impose a duty of care.

In examining the nature of the plaintiff-lender relationship, the court found that the Jacques and the bank entered into a binding contractual agreement whereby the bank agreed to process the loan application in return for a $144 application fee. The court found that the lender made two express promises and one implied promise, each supported by valid consideration. It expressly agreed to process the loan application and to "lock in" the interest rate of 11 7/9% for a period of ninety days. Implicit in the undertaking to process the loan application was the agreement to do so with reasonable care.

The court noted that these promises were supported by two kinds of valid consideration. First, the Jacques paid $144 for the appraisal and credit report. The lender contended that this payment did not constitute consideration, since the fee covered out-of-pocket costs to the lender, with the money passed on to others. The court disagreed, noting that consideration supporting a promise is valid even if paid to a third person. Second, the court reasoned that the lender obtained a business advantage and potential benefit sufficient

---

> the relationship of the parties on the other . . . . Therefore, if the risk created by negligent conduct is no greater than one of economic loss, generally no tort duty will be found absent a showing of privity or its equivalent.

Id. at 537, 515 A.2d at 761. The support given for this statement is dubious. *See generally* PROSSER & KEETON, THE LAW OF TORTS (5th ed. 1984) [hereinafter PROSSER & KEETON]. In all instances in which the issue of proximity is emphasized, the question concerns the appropriateness of a tort claim by a remote party not in contractual privity with the defendant. *See infra* note 115. Requiring a certain degree of proximity in such cases is not the same as holding that a tort claim is proper when there is contractual privity. Instead, it has been suggested that courts should consider the following factors in deciding whether to allow recovery for economic losses: the interests of the parties, the interests of society and a consideration of economic efficiency and the future effects likely to result from an imposition of liability. Note, *A Framework for Determining Liability For Negligently Caused Economic Losses*, 1986 B.Y.U. L. REV. 177, 183-95 (1986) [hereinafter Note, *Framework*].

65. It can be argued that this position is consistent with the RESTATEMENT (SECOND) OF TORTS. Section 323 recognizes a duty of care in a gratuitous undertaking when negligence is a proximate cause of physical harm but not when it is a proximate cause of economic loss. By implication, recognition of a tort duty of care in an economic loss situation requires an undertaking for consideration. RESTATEMENT (SECOND) OF TORTS § 323 (1977). *But see infra* notes 97-101 and accompanying text. Some jurisdictions do not consider the nature of the risk of harm as a factor in determining the existence of a duty of care. These courts find no rational basis to distinguish between a risk of personal injury and a risk of economic loss.

66. *Jacques II*, 307 Md. at 536, 515 A.2d at 760.

to support its promises. Considering the practicalities of the home loan market and particularly the expense of each application, the court found that filing an application had the effect of taking the customer out of the market at least temporarily. This created a business advantage for the lender.[67]

After finding a contractual relationship between the applicant and the lender, the court asked whether it should recognize a concomitant duty in tort. In addressing the issue the court focused on three factors: 1) the "rather extraordinary financing provisions," coupled with the dramatic increase in interest rates, which left the Jacques "particularly vulnerable and dependent upon the Bank's exercise of due care;"[68] 2) the lender's awareness of the Jacques' limited options and of its own obligations; and 3) the nature of the banking industry,[69] which is a business affecting the public interest.[70] The court expressly rejected the lender's contention that the largely judgmental process of evaluating loan applications defied the imposition of a standard of care. The court also rejected the lender's theory that since the Jacques might have sued for breach of contract, there was no need to recognize a corresponding duty in tort.[71]

---

67. *Id.* at 538, 515 A.2d at 761.

68. *Id.* at 540, 515 A.2d at 762.

69. The banking industry is regulated to protect the public interest. MD. FIN. INST. CODE ANN. § 203(b) (1985 cum. supp.). The court stated that a duty of care generally arises from contractual dealings with professionals. *Id.* at 541, 515 A.2d at 763. This distinction is not made by all courts. *See, e.g.*, Flintkote Co. v. Dravo Corp., 678 F.2d 942 (11th Cir. 1982) (court refused to impose a duty of care upon the defendant for economic loss regardless of his status as a professional).

70. The court compared the banking industry with the insurance industry. Some courts have imposed a duty on insurance companies to act promptly in reviewing submitted applications for insurance. *See, e.g.*, United States Fire Ins. Co. v. Cannon, 349 F.2d 941 (8th Cir. 1965); Duffy v. Bankers' Life Ass'n, 160 Iowa 19, 139 N.W. 1087 (1913). However, as the court admitted, the general rule is that no duty is created to process the application promptly. 307 Md. at 538-39, 515 A.2d at 762. *See also* Zayc v. John Hancock Mut. Life Ins. Co., 338 Pa. 426, 13 A.2d 34 (1940). *See generally* Funk, *The Duty of an Insurer to Act Promptly on Application*, 75 U. PA. L. REV. 207 (1927); Prosser, *Delay in Acting on an Application for Insurance*, 3 U. CHI. L. REV. 39 (1935) [hereinafter Prosser, *Delay*]; Note, *Insurance—The Effect of the Insurer's Delay in Acting on an Application for Insurance*, 36 TEMPLE L.Q. 84 (1962); Note, *Insurance—Tort Liability—Delay in Acting Upon an Application*, 16 OHIO ST. L.J. 111 (1955); Comment, *Insurance—Liability of Insurer for Failure to Settle—Tort or Contract Basis for Action*, 34 N.Y.U. L. REV. 783 (1959). For a more complete discussion of an insurer's liability for delay in processing an application, see *infra* notes 106-07 and accompanying text.

71. The court noted that in instances of wrongful dishonor, the depositor is given an option of choosing between a tort or contract action. 307 Md. at 538, 515 A.2d at 761, *citing* Magness v. Trust Co., 176 Md. 528, 6 A.2d 241 (1939). The court, however, failed to recognize the confusion that arose in court treatment from the question of the nature of the action for wrongful dishonor. U.C.C. § 4-402 refuses to specify a theory of recovery. *See* U.C.C. § 4-402, official comment 2 (1978). *See generally* Dow, *Damages and Proof in Cases of Wrongful Dishonor: The Unsettled Issues Under UCC Section 4-402*, 63 WASH. U. L.Q. 237 (1985). Although *Jacques II* did not clearly enunciate this position, wrongful dishonor is an example

IV. Analysis

One major distinction between the *Jacques I* and *Jacques II* holdings lies in the threshold determination of whether acceptance of the Jacques' loan application created a contractual relationship with the lender. The focus of the issue shifted drastically from *Jacques I* to *Jacques II*. The Court of Special Appeals in *Jacques I* did not consider whether the acceptance and processing of a loan application created a contract.[72] The Court of Appeals in *Jacques II* would not even consider the issue of a tort duty of care in an economic loss situation without first determining that there was a contract or its equivalent.[73] Thus, the question of the existence of a contractual relationship must be addressed.

A. Loan Applications As Contracts

The decision by the court in *Jacques II* is sound with respect to the contract issue. A lender is free to accept or reject a loan application.[74] Once a lender accepts a loan application and payment for appraisal and credit check costs, however, it has made a contract. Contrary to the position that processing the loan application and determining the applicant's loan eligibility is merely the procedure by which the lender determines whether it will do business with the applicant, the lender's acceptance of the loan application for processing includes express and implied promises supported by consideration from the applicant. In exchange for payment of the bank's costs in having the property appraised and the applicant's creditworthiness checked and for the business advantage of the loan potential, the lender promises: 1) to fairly and accurately determine the applicant's loan eligibility; and 2) if eligible, to make the loan at the rate and term promised, and in the eligible amount.[75] In the instant case, an agreement was reached in which the lender agreed to process the loan application in return for payment of a fee. Therefore, it is clear

---

of an action for which a defendant might incur liability in tort or in contract. *See, e.g.*, Kendall Yacht Corp. v. United Cal. Bank, 50 Cal. App. 3d 949, 123 Cal. Rptr. 848 (1975); Bank of Louisville Royal v. Sims, 435 S.W.2d 57 (Ky. Ct. App. 1968).

72. *See supra* notes 46-50 and accompanying text.

73. *See supra* notes 64-65 and accompanying text.

74. The lender is obviously subject to statutory restrictions in this decision-making process.

75. The term "eligible" includes discretionary judgments by the lender as to whether the applicant should be granted a loan. Such eligibility should be determined by some reasonable process, rather than in an arbitrary fashion. It should be remembered, however, that the lender in *Jacques* agreed to process the loan application; it did not agree to *lend money*. It was, at this point, free to refuse to extend a loan. This is relevant to the issue of damages as well as to the issue of proximate cause.

that the Jacques could have properly asserted a claim for breach of contract.[76]

B. Loan Applications As Creating a Concomitant Duty of Care in Tort

The Court of Appeals in *Jacques II* found that the lender and the plaintiff entered into a contractual agreement whereby the Bank promised to process the Jacques' loan application in return for a $144 loan application fee.[77] That agreement contained an implicit promise to process the application using reasonable care. Although the case could have been initiated under breach of contract theories, it was, instead, pursued as a negligence action. Therefore, the appropriateness of negligence relief in a breach of contract context must be examined.

---

76. The Jacques might have faced difficulty recovering substantial damages under a breach of contract theory. If a lender mistakenly determines an applicant's loan eligibility, the applicant can sue for breach of contract damages in one of two situations: 1) when the applicant is forced to obtain more costly financing to purchase the house; and 2) when the applicant cannot complete the purchase transaction because of lack of financing.

In the first situation, the plaintiff's duty to mitigate damages requires him to seek the least costly alternative financing in a timely and reasonable way. When interest rates are escalating rapidly over a short period of time, the difference in cumulative financing costs for a fixed-rate thirty-year mortgage could be substantial. One measure of damages is the difference between the thirty-year cost of alternative financing and the thirty-year cost that would have been incurred based on an accurate determination of loan eligibility. A major problem with this standard is determining the applicable period of time for calculation. It might not be reasonable to assume that the plaintiff/purchaser with a thirty-year mortgage at a higher rate would actually remain in the home for the length of the thirty-year mortgage. Nor would it be reasonable to require an annual payment of the "running difference" until the property is sold.

A reasonable measure of damages might require the negligent lender to pay off the mortgage loan owed to the second lender. A mortgage loan would then be prepared with the first lender for the amount and at the rate of the initial loan eligibility determination, had it been accurate. It would be even more difficult to establish a measure of damages for the situation in which a purchase transaction cannot be completed because of lack of financing and when another party has purchased the home in the interim.

Although it is not clear what constituted the $92,000 damages sought in the *Jacques* case, it is presumed that at least some portion represented consequential damages. Consequential damages are recoverable in breach of contract cases only when they are reasonably foreseeable at the time of contract formation. Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854). See *infra* notes 134-140 and accompanying text for a discussion of this issue as it relates to a comparison between tort and contract actions. The likelihood of consequential damages being sought is greater in the commercial than the consumer applicant situation. See *infra* notes 126-30, proposing different treatment for consumer and commercial situations.

77. The lender argued that no consideration supported any contractual agreement, since the $144 fee was "passed-on" to others. (Basically, the fee covered expenses of processing such as an appraisal and credit search.) The court rejected this argument. The fact that a payment is passed on to or paid directly to a third party does not render the agreement unsupported by consideration. In addition, the application process created a business advantage benefiting the Bank. *See supra* note 67 and accompanying text. Furthermore, even if the promise to process was not supported by consideration, a gratuitous promise might give rise to a duty of care. *See infra* note 83 and accompanying text.

To successfully maintain a negligence action, one must establish four elements: 1) the defendant owed the plaintiff a duty of care; 2) the defendant breached this duty of care; 3) damages occurred; and 4) these damages were proximately caused by the defendant's breach.[78] In *Jacques*, the major obstacle to recovery was the establishment of a duty owed to the Jacques.[79] The question that arises is the extent to which creation of a contract establishes a duty owed from lender to borrower.[80] In other words, under what circumstances can breach of the contract constitute breach of a duty of care[81] equalling negligence? The interrelationship between tort[82] and contract actions must be explored.[83]

---

78. *See generally* Cramer v. Housing Opportunities Comm'n, 304 Md. 705, 501 A.2d 35 (1985).

79. Recall that the Jacques were able to demonstrate deviation from the applicable standard in several ways. *See supra* note 42.

80. It is not unusual for the same set of facts to give rise to claims which are both contractual and tortious in nature. For example, when a plaintiff-buyer is injured by a defective and negligently manufactured product, he can choose to sue under the tort of negligence, breach of contract (warranty) or strict liability. *See, e.g.*, Flintkote Co. v. Dravo Corp., 678 F.2d 942 (11th Cir. 1982). This is, however, limited by the nature of the harm suffered by the plaintiff. Under the majority rule, the plaintiff is limited to the contract action where the loss suffered is purely economic. *See, e.g.*, East River Steamship Corp. v. Transamerica Delaval, Inc., 106 S. Ct. 2295 (1986). See *infra* notes 95-113 and accompanying text for a discussion of the relevance of the nature of loss to the availability of tort relief.

81. Plaintiff established that the defendant failed to exercise due care in processing the loan application in several ways. *See supra* note 42 and accompanying text.

82. Plaintiff's suit was brought upon several grounds, all tortious in nature. *See supra* notes 38-40 and accompanying text. The Jacques did not initiate a claim for breach of contract. The plaintiffs alleged damages in the amount of $92,000. Winchurch, *supra* note 40, at 1. It is unclear exactly what losses this figure includes. Therefore, it is impossible to determine whether these damages would be compensable under a breach of contract theory. See generally PROSSER & KEETON, *supra* note 64, at 664-65, for a discussion of the differences in damages recoverable under each theory.

83. Absent an agreement between the parties, the lender does not owe a duty to process an application submitted by the Jacques. It is, in fact, well-settled that one does not have a duty to undertake affirmative action on behalf of strangers. This statement is supported by the plethora of cases dealing with the lack of a duty to aid one in peril. *See, e.g.*, Munson v. Otis, 396 A.2d 994 (D.C. 1979) (home improvement operator owed no duty to general public); Ashburn v. Anne Arundel County, 306 Md. 617, 510 A.2d 1078 (1986) (police owed no duty to protect injured plaintiff from drunken driver); Furr v. Spring Grove State Hospital, 53 Md. App. 474, 454 A.2d 414 (1983) (psychiatrist owed no duty to protect murder victim from criminal acts of patient); H.R. Moch Co., Inc. v. Rensselaer Water Co., 247 N.Y. 160, 159 N.E. 896 (1928) (waterworks company not liable for failure to supply water to plaintiff whose house burned). *See generally* PROSSER & KEETON, *supra* note 64, at 375-77. This principle is true except in unusual circumstances such as those detailed in RESTATEMENT (SECOND) OF TORTS § 314A (1977) (common carrier, innkeeper, and possessor of land who holds it open to the public). Moreover, since a lender is free to choose with whom it desires to do business, it is under no obligation to enter into a contractual relationship with an applicant.

It can be argued, however, that although the lender in *Jacques* was under no obligation, a duty arose when the lender gratuitously entered into a relationship with the plaintiffs. It was upon this basis that the dissent in *Jacques I* would have predicated liability. *See supra* notes 54-56 and accompanying text. When one undertakes performance of a task, even one which he has no duty to undertake, a limited duty arises. This duty, in general, arises where the plaintiff

Tort obligations are imposed by law;[84] contractual obligations are imposed by agreement between the parties. An independent tort action will be permitted only when the breach is a breach of duty imposed by law and not *merely* a breach of duty imposed by contract.[85] In determining whether, in any given situation, the duty is imposed by law or merely by contract, courts have traditionally used one of two approaches.[86]

---

relies upon the gratuitous promise of the defendant and such reliance causes harm. *See generally* PROSSER & KEETON, *supra* note 64, at 378-382. It can be argued that the Jacques relied on the lender's promise to process the loan application, presumably with the requisite degree of care, by failing to seek alternative financing. As a result, they were injured by the increase in interest rates that occurred during the period that the defendant was processing the application. The defendant, by voluntarily accepting the loan application, worsened the plaintiff's condition, and harm resulted.

This reasoning, although appealing at first glance, merits closer attention. The liability under this doctrine is generally extended to personal or property injury cases rather than to cases of economic loss. Restatement § 323, by its express terms, applies to instances where the plaintiff suffers "physical harm." *See supra* note 55. The dissent in *Jacques I* found this principle applicable by analogy. *See supra* notes 54-56 and accompanying text. See also *infra* notes 97-113 and accompanying text for a discussion of the difference in imposition of liability based upon a categorization of the type of injury (*e.g.*, personal injury, property damage or economic loss).

It must also be remembered that even if the loans had been processed properly, the lender might have denied the loan application upon more subjective criteria. The Jacques must have been aware of the potential for denial; therefore, they could not have justifiably relied upon the lender's action in accepting the loan application without any promise of loan extension. This argument is also relevant to the question of proximate cause. *See, e.g.*, Kemp v. Armstrong, 40 Md. App. 542, 392 A.2d 1161 (1978), where the court refused to impose tort liability for negligent performance of a voluntarily assumed duty. The court equated lack of reliance upon the defendant's promise to lack of proximate cause. This issue was not addressed by the *Jacques II* court. See Elkton Auto Sales Corp. v. Maryland, 53 F.2d 8 (4th Cir. 1931) for a statement of the meaning of proximate cause in Maryland.

84. PROSSER & KEETON, *supra* note 64, at 655.

85. *Id.* at 656. United States v. Bethlehem Shipbuilding Corp., 25 F.2d 157 (D. Md. 1928); John Deere Co. v. Short, 378 S.W.2d 496 (Mo. 1964); Mulvey v. Staab, 4 N.M. (Gild., E.W.S. ed.) 172, 12 P. 699 (1887); Curtis, *Damage Measurements for Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161, 163-64 (1986); Morgan, *The Negligent Contract-Breaker*, 58 CAN. B. REV. 299, 302 (1980); Note, *Should Contract or Tort Provide the Cause of Action When a Plaintiff Seeks Recovery Only for Damage to the Defective Product Itself?*, 10 N. KY. L. REV. 489, 497 (1983) [hereinafter Note, *Contract or Tort*]. A duty in tort is said to arise where there would be a duty to use reasonable care if the same act were done gratuitously without a contract. Morgan, *supra* at 302, 307.

86. Courts generally adopt one of the two approaches without any consideration of the other; thus, courts which discuss misfeasance and nonfeasance fail to consider the type of loss suffered without explanation. No discernible differences can be found between the cases falling into the different categories. While products liability cases comprise a large part of the cases that consider the type of loss suffered, *see, e.g.*, East River Steamship Corp. v. Transamerica Delaval, Inc., 106 S. Ct. 2295 (1986); Flintkote Co. v. Dravo Corp., *supra* note 69, they are not the only cases in this category. *See, e.g.*, McClain v. Harveston, 152 Ga. App. 422, 263 S.E.2d 288 (1979) (contractor liability); Foxcroft Townhome Owners Ass'n v. Hoffman Rosner Corp., 105 Ill. App. 3d 951, 435 N.E.2d 210, 215 (1982) (builder liability); Redarowicz v. Ohlendorf, 95 Ill. App. 3d 444, 420 N.E.2d 209 (1981) (builder liability). *But see* Sabella v. Wisler, 59 Cal. 2d 21, 377 P.2d 889, 27 Cal. Rptr. 689 (1963) (court refused to limit tort relief to cases of personal injury or property damage). The Sabella court found the cases in the products liability area inapplicable and held that the "liability of a contractor should be deter-

C. *Misfeasance*[87] *v. Nonfeasance*[88]

Courts that adopt the misfeasance versus nonfeasance approach hold that one can recover in tort, as well as in contract, for misfeasance, but not for nonfeasance.[89] Under this theory, failure to begin performance of an agreement to lend money is actionable in contract but not in tort.[90] On the other hand, once the defendant has taken some action to begin performance,[91] the likelihood of imposing tort liability increases.[92] Contractors,[93] abstractors,[94] architects[95] and others[96] have been found liable in negligence for defective performance of the contractual promise. While it is not always easy to determine whether sufficient action has been taken on the part of the defendant to constitute misfeasance, rather than nonfeasance, it appears that, in the case at hand, the bank had begun performance.

---

mined by consideration and weighing of the various factors bearing upon liability . . ., rather than by resort to special rules or distinctions." *Id.* at 29, 377 P.2d at 894, 27 Cal. Rptr. at 694. The choice between approaches is also not made upon a jurisdictional basis. Within jurisdictions, courts will consider misfeasance versus nonfeasance in some cases, and the type of loss in other cases.

87. Misfeasance is "negligent affirmative conduct in the performance" of the contractual promise. PROSSER & KEETON, *supra* note 64, at 656.

88. Nonfeasance is failing to do what one has promised to do. *Id.* at 657.

89. *Id.* at 656-662. This distinction can be traced to the development of contract and tort law. *Id.* at 658-60. *See also* MacGrath, *The Recovery of Pure Economic Loss in Negligence — An Emerging Dichotomy*, 5 OXFORD J. LEGAL STUD. 350, 360-71 (1985). For cases in which the distinction between misfeasance and nonfeasance was determinative, see, *e.g.*, E & M Construction Co. v. Bob, 115 Ga. App. 127, 153 S.E.2d 641 (1967); Mauldin v. Sheffer, 113 Ga. App. 874, 150 S.E.2d 150 (1966); Hart v. Ludwig, 347 Mich. 559, 79 N.W.2d 895 (1956); Chase v. Clinton County, 241 Mich. 478, 217 N.W. 565 (1928).

90. *See, e.g.*, John Deere Co. v. Short, 378 S.W.2d 496 (Mo. 1964); Farabee-Treadwell Co. v. Union & Planters Bank & Trust Co., 135 Tenn. 208, 186 S.W. 92 (1916). These cases were both cited in *Jacques I* but were not discussed in *Jacques II*.

91. A great deal of confusion exists with respect to the degree of action required before nonfeasance becomes misfeasance. *See generally* PROSSER & KEETON, *supra* note 64, at 661-62. The test has been stated as "whether the defendant's performance, as distinct from his promise or his preparation, has gone so far that it has begun to affect the interests of the plaintiff beyond the expected benefits of the contract itself, and is to be regarded . . . as a positive act assuming the obligation." *Id.* at 662.

92. *Id.* at 660.

93. *See, e.g.*, United States v. Bethlehem Shipbuilding Corp., 25 F. 157 (D. Md. 1928); Ehrenhaft v. Malcolm Price, Inc., 483 A.2d 1192 (D.C. 1984); E & M Construction Co. v. Bob, 115 Ga. App. 127, 153 S.E.2d 641 (1967).

94. *See, e.g.*, Dorr v. Massachusetts Title Ins. Co., 238 Mass. 490, 131 N.E. 191 (1921).

95. Friendship Heights Associates v. Vlastimil Koubek, 573 F. Supp. 100 (D. Md. 1983) (architect not liable for negligence because of lack of proximate cause); Ehrenhaft v. Malcolm Price, Inc., 483 A.2d 1192 9D.C. App. 1984); Cutlip v. Lucky Stores, Inc., 22 Md. App. 673, 325 A.2d 432 (1974). For a discussion of architects' tort liability, see generally Archer, *Architects' Liability to Third Party Contractors for Economic Loss Resulting from Faulty Plans and Specifications*, 27 ARIZ. L. REV. 139 (1985); Jackson, *The Role of Contract in Architectural and Engineering Malpractice*, 51 INS. COUNSEL J. 517 (1984).

96. *See, e.g.*, Gagne v. Bertran, 43 Cal. 2d 481, 275 P.2d 15 (1954) (test hole driller); Mauldin v. Sheffer, 113 Ga. App. 874, 150 S.E.2d 150 (1966) (engineer); Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922) (public bean weigher).

The application was accepted and processed. The plaintiffs alleged that the application was processed improperly. Thus, this action could have been correctly classified as a complaint for misfeasance, for which tort liability might be available.

D. Type of Loss Suffered

Under this approach, a distinction is made with respect to the type of injury suffered by the plaintiff: personal injury, property damage, or economic loss.[97] Courts adopting this approach[98] hold that one can recover in tort, as well as in contract, for personal or property damage; liability is, however, limited to contract liability in instances of purely economic loss.[99] For example, a builder or contractor is generally not liable in tort for economic loss suffered due to delays or defects in construction.[100] He would, however, be liable for personal or property damage stemming from negligent performance of the contract.[101]

One of the few instances[102] in which tort recovery has been permitted for economic loss is where the defendant accepted an application for insurance, delayed processing the application and then denied the insurance.[103] The legal issue in the insurance cases revolves around the question of whether the defendant owes the plaintiff a

97. Economic loss is essentially commercial in nature and can be broken down into two types, direct and indirect. Direct economic loss is damage to the thing contracted for (*e.g.*, the product sold or the building built). Indirect economic loss is consequential damage suffered because of the breach. Wildermuth, *Recovery of Economic Loss in Products Liability Actions*, 30 TRIAL L. GUIDE 229 (1986); Note, *Torts: Recovery of Damages for Economic Loss Through the Use of Strict Liability in Tort*, 38 OKLA. L. REV. 347 (1985) [hereinafter Note, *Recovery*].

98. This liability might be subject to the limitations discussed above with respect to misfeasance and nonfeasance.

99. *See generally* PROSSER & KEETON, *supra* note 64, at 657. *See also* Flintkote Co. v. Dravo Corp., 678 F.2d 942 (11th Cir. 1982); Clark v. International Harvester Co., 99 Idaho 326, 581 P.2d 784 (1978); Album Graphics, Inc. v. Beatrice Foods Co., 87 Ill. App. 3d 338, 408 N.E.2d 1041 (1980).

100. *See, e.g.*, Flintkote Co. v. Dravo Corp., 678 F.2d 942 (11th Cir. 1982); McClain v. Harveston, 152 Ga. App. 422, 263 S.E.2d 228 (1979); Foxcroft Townhome Owners Ass'n v. Hoffman Rosner Corp., 105 Ill. App. 3d 951, 61 Ill. Dec. 721, 435 N.E.2d 210 (1982); Redarowicz v. Ohlendorf, 95 Ill. App. 3d 444, 50 Ill. Dec. 892, 420 N.E.2d 209 (1981); C.H. Leavell & Co. v. Vilbig Bros., Inc., 335 S.W.2d 211 (Tex. 1960).

101. Similarly, architects and engineers have been found liable in tort for breach of contractual obligations when the result was property damage or personal injury. *See supra* notes 93-96 and accompanying text.

102. Tort recovery has been allowed in a limited number of cases for breach of the contractual covenant of good faith and fair dealing. *See supra* note 26.

103. *See, e.g.*, United States Fire Ins. Co. v. Cannon, 349 F.2d 941 (8th Cir. 1965); Travelers Ins. Co. v. Anderson, 210 F. Supp. 735 (W.D.S.C. 1962); Valdez v. Taylor Automobile Co., 129 Cal. App. 2d 810, 278 P.2d 91 (1955); Duffy v. Bankers' Life Ass'n, 160 Iowa 19, 139 N.W. 1087 (1913).

duty to respond to the application in a reasonably timely manner.[104] Tort liability has been predicated upon the defendant's failure to respond in a more timely manner.[105] Tort liability with respect to delay in acting upon insurance applications is, however, the exception rather than the rule. The majority of cases[106] hold that no duty of care arises from merely accepting the application for insurance.[107]

The distinction between economic and other loss is derived from the difference between the basic substance of a tort action and a contract action — the nature of the remedy sought. For example, in a products liability claim when a plaintiff suffers purely economic loss, majority rule denies recovery in either negligence or strict liability, limiting recovery to the contract breach of warranty action.[108] The Supreme Court, in *East River Steamship Corp. v. Transamerica Delaval, Inc.*,[109] based this denial upon the nature of the injury in an economic loss case.[110] The Court reasoned that economic loss is

104. The question in *Jacques* did not involve timely response to the application but rather the reasonableness of the response.

105. In the majority of cases finding liability, the duty of care was created by the principle that, when one, even gratuitously, undertakes an obligation upon which another might justifiably rely, a duty to reasonably perform that undertaking is found. *See supra* notes 54-56 (doctrine applied by the court in *Jacques I*). *See also supra* note 83.

106. *See, e.g.*, Patten v. Continental Casualty Co., 162 Ohio St. 18, 120 N.E.2d 441 (1954); Zayc v. John Hancock Mut. Life Ins. Co., 338 Pa. 426, 13 A.2d 34 (1940); Funk, *supra* note 70; Prosser, *Delay*, *supra* note 70. *See also supra* note 70. *See also infra* note 123 and accompanying text.

107. This is true even when the application for insurance is included with a premium payment. If the application is rejected, the insurance company is merely required to return the premium.

108. The leading case for the majority is Seely v. White Motor Co., 63 Cal. 2d 9, 403 P.2d 145, 45 Cal. Rptr. 17 (1965). See Wildermuth, *supra* note 97 at 229 n.2, for the states adopting the majority approach. *See also* Note, *Recovery*, *supra* note 97 at 352 n.38. For a case following the majority approach, see, *e.g.*, S.M. Wilson & Co. v. Smith Int'l, Inc., 587 F.2d 1363 (9th Cir. 1978). The leading case setting forth the minority rule allowing recovery for economic loss is Santor v. A and M Karagheusian, Inc., 44 N.J. 52, 207 A.2d 305 (1965). See Wildermuth, *supra* note 97 at 234 n.3, for the states adopting the minority approach. *See also* Note, *Recovery*, *supra* note 97, at 350 n.25. For a case following the minority approach, see, *e.g.*, State *ex rel* Western Seed Prod. Corp. v. Campbell, 250 Or. 262, 442 P.2d 215 (1968).

The availability of tort relief for economic loss in products liability cases has been the subject of numerous articles. *See, e.g.*, Perlman, *Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine*, 49 U. CHI. L. REV. 61, 70-75 (1982); Wildermuth, *supra* note 97; Note, *Framework*, *supra* note 64; Note, *Recovery*, *supra* note 97; Note, *Contract or Tort*, *supra* note 85.

109. 106 S. Ct. 2295 (1986). This case reached the Supreme Court as a products liability action in admiralty.

110. This rationale would be equally applicable to non-products liability actions; however, the rationale might not be applicable to certain consumer transactions. The Court examines the differences between personal injury or property loss and economic loss, concluding that economic loss is less "overwhelming." It relies upon the fact that the commercial plaintiff is likely to be insured against economic losses. *Id.* at 2302. This insurance would not be feasible, even if available, to the consumer plaintiff. Similarly, the Court is willing to limit liability to the terms of the contract in a commercial setting where there is no unequal bargaining power

the "essence of a warranty [contract] action, through which a contracting party can seek to recoup the benefit of its bargain."[111] In fact, an action in which a plaintiff sues to recover loss of the benefit of its bargain[112] is "traditionally the core concern of contract law."[113]

E. Jacques II Rationale

Although the result reached by the *Jacques II* court was proper under the facts presented, the court's opinion fails, in several respects, to properly address the issues presented. First, it fails to completely recognize the common law distinctions relevant to imposition of a duty of care. Second, it fails to adequately distinguish prior case law barring negligence liability against lenders. Furthermore, the court fails to appreciate the implication of its holding.[114]

A tort duty of care exists when negligent conduct is the proximate cause of physical harm to reasonably foreseeable plaintiffs, regardless of the proximity of the relationship between plaintiff and defendant. The *Jacques II* court held, however, that a duty of care will not be recognized in purely economic loss situations unless there is a "special nexus" amounting to contractual privity[115] or its

---

that might affect the parties' own risk allocation. *Id.* at 2303. Again, this might not be the case in some consumer contracts.

111. *Id.* at 2300.

112. This would include damage to the product itself, as well as consequential damages such as lost profits.

113. *East River*, 106 S. Ct. at 2302. See *infra* notes 133-40 and accompanying text for a discussion of the differences between tort and contract remedies.

114. Some scholars assert that contract actions have been, or will be, supplanted by tort actions. *See* G. GILMORE, THE DEATH OF CONTRACT (paperback ed. 1974). *See also* Metzger & Phillips, *Promissory Estoppel and the Evolution of Contract Law*, 18 AM. BUS. L.J. 139 (1980), for a discussion of the history and the interrelationship of tort and contract actions as they relate to the doctrine of promissory estoppel.

115. The court found two cases persuasive in determining that the nature of the relationship in instances of economic loss is crucial. In Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922), the court found a public bean weigher liable to a buyer of beans for negligent weighing. The weigher was hired by the seller and was therefore in contractual privity only with the seller. Similarly, in Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931), the court considered imposition of liability upon an accountant where his negligence in preparing a balance sheet was responsible for losses to a third party who made loans to the corporation in reliance upon the financial statements. While the court is correct in its conclusion that the nature of the relationship is important in determining whether a duty of care arises in negligence cases, the cases cited do not support the more expansive *Jacques II* holding. The court stated that "significant in both of these cases is the fact that the court had no difficulty in finding that the actors under each contract owed a tort duty of due care to the parties with whom they had contractual privity or its legal equivalent. 307 Md. at 536, 515 A.2d at 760-761 (1986). It must be remembered that that question was addressed in neither *Glanzer* nor *Ultramares*. The courts in both cases were examining *only* the question of liability to third parties with whom the defendants were not in contractual privity. In each case, it was doubtful whether the third party would be able to recover for breach of contract as a mere

equivalent between the plaintiff and defendant.[116] The *Jacques II* court reached this conclusion by relying on cases in which no contractual privity existed.[117] Such cases stand for the proposition that lack of contractual privity should not bar tort recovery where the relationship is sufficiently close. They *cannot* be read for the proposition that a plaintiff injured by a negligent breach of contract can elect a cause of action in tort[118] or contract even for pure economic loss. The court's conclusion is not adequately supported by the cases cited.[119]

Under *Jacques II*, finding a special nexus is a prerequisite to creating a duty of care in economic loss cases. It is not, however, sufficient. The court found that certain policy considerations establish the duty in combination with the closeness of the relationship. The court considered a number of circumstances relevant to its recognition of a concomitant tort duty of care. The court first cited the rather extraordinary financing provisions that left the Jacques vulnerable and dependent upon the lender's exercise of due care.[120] The Jacques were indeed vulnerable, but they were vulnerable by their own choice, and they were not unsophisticated people.[121] The lender, however, was free to accept or to reject the loan application, and

---

incidental third party beneficiary. *See, e.g.*, Marlboro Shirt Co. v. American Dist. Tel. Co., 196 Md. 565, 77 A.2d 776 (1951) (plaintiff's claim as a third party beneficiary was barred against a contractor due to lack of privity). Tort recovery might have been the only option. For a discussion of the role of both the *Glanzer* and *Ultramares* cases in the development of the trend toward relaxation of privity requirements, see G. WHITE, TORT LAW IN AMERICA — AN INTELLECTUAL HISTORY 131-35 (1980). In *Jacques*, recovery for breach of contract was clearly an option since the *Jacques II* court found a contract. *See supra* note 67 and accompanying text. Moreover, the tort liability in *Glanzer* and *Ultramares* would be akin to negligent misrepresentation rather than negligent performance, which is generally an independent tort. *See generally* PROSSER & KEETON, *supra* note 64, at Chapter 15.

116. *See supra* note 64 and accompanying text. Apparently, the direct relationship created by reasonable reliance on the gratuitous undertaking of another for one's benefit is not enough of a "special nexus" to allow raising the question of a tort duty of care.

117. In such cases where there has been a relaxation of the privity requirement, courts appear to be willing to allow third parties to recover for economic losses suffered under tort theories. *See, e.g.*, Dorr v. Massachusetts Title Ins. Co., 238 Mass. 490, 131 N.E. 191 (1921); Glanzer v. Shepard, 233 N.Y. 236, 315 N.E. 275 (1922); State *ex rel* Western Seed Prod. Corp. v. Campbell, 250 Or. 262, 442 P.2d 215 (1968); Archer, *supra* note 95; Jones, *Economic Loss-Expanding the Duty of Care*, 132 NEW L.J. 1091 (1982); MacGrath, *supra* note 89; Probert, *Negligence and Economic Damage: The California-Florida Nexus*, 33 U. FLA. L. REV. 485 (1981).

118. Where the gist of the action is contract, a contract action should lie. Dawson Cotton Oil Co. v. Kenan, McKay & Speir, 21 Ga. App. 688, 94 S.E. 1037 (1918).

119. Prosser and Keeton state that tort recovery is not appropriate under such circumstances. "Such a claim should not be translatable into a tort action in order to escape some roadblock to recovery on a contract theory." PROSSER & KEETON, *supra* note 64, at 659.

120. *Jacques II*, 307 Md. at 540, 515 A.2d at 762.

121. Mr. Jacques was, in fact, a government attorney.

accepted it with knowledge of the special financing provisions in the purchasing contract. Agreeing to act with knowledge of the other party's need and reliance required careful consideration of the application.

The second crucial factor cited by the *Jacques II* court was the recognition of the banking industry as a business affected with a public interest and subject to legislative requirements expressive of public policy.[122] Any loan application accepted by a lending institution would, therefore, create not only a contract but also a concomitant tort duty of care. In other words, the policy consideration that justified creating a tort duty of care in this case was merely the fact that the defendant was a bank.

The question that must be addressed is to what extent should banks be treated differently than other businesses? States charter and regulate lending institutions in a much different way than other businesses. Public policy requires a high standard of integrity from those in control and close scrutiny of lending operations. Does this public policy concern, however, justify the imposition of a duty to use reasonable care in the course of the lending operations?

The insurance industry is also an industry affected with public policy.[123] In the majority of cases, courts have refused to find insurance companies liable for negligence for delay in processing insurance applications.[124] There are, however, crucial differences. First,

---

122. The court held:

> Unlike most other corporations, in Maryland a state bank may not be chartered until there has been an investigation by a state official and a determination that "[t]he character, responsibility, and general fitness of the incorporators and directors named in the articles command confidence and warrant belief that the business of the proposed commercial bank will be conducted honestly and efficiently . . . and [that] [a]llowing the proposed commercial bank to engage in business . . . [w]ill promote public convenience and advantage . . . ." . . . The recognition of a tort duty of reasonable care under the circumstances presented by this case is thus consistent with the policy of this State as expressed by the Legislature, and reasonable in light of the nature of the banking industry and its relation to public welfare.

Id. at 542-43, 515 A.2d at 764 (citations omitted).

123. In arguing against imposition of tort liability for delay in application for insurance, Prosser recognizes the similarities. Two arguments have been advanced for imposing liability. Some scholars assert that a duty of care arises based upon the state franchise of the insurance company. Prosser states that nothing in the state franchise should impose liability. He recognizes that banks also operate under state franchise. Thus, the franchise "should impose no more duty to act without delay upon applications than would be required of a bank receiving a request for a loan." Prosser, *Delay, supra* note 70, at 52. Another group asserts that insurance is a business so affected with public interest that a duty to act in a timely fashion arises. Prosser rejects this assertion stating that "banking is affected with a public interest, but it never has been suggested that a bank may be required to act promptly on a requested loan . . . ." *Id.* at 52-53.

124. *See supra* notes 106-107 and accompany text. *See also supra* note 70.

the lender in *Jacques* was found liable for negligence in the process of evaluating the application, not for mere delay in beginning the process. In fact, courts have shown a willingness to impose tort liability upon insurance companies for bad faith breach of contract.[125] Second, lending institutions exist to facilitate the public's *economic* well-being and, accordingly, should be held responsible for any economic loss due to their negligence.[126] This stems from the nature of the loan source and not the kind of loan.

Imposition of a concomitant tort duty would, however, be inappropriate in *all* cases where the breach of contract resulted in purely economic loss. Where the relationship between the parties is commercial in nature, recovery for economic loss should be limited to contract. Although the distinction between commercial and consumer contracts has traditionally not been made, the Supreme Court emphasized the commercial nature of the contract in the *East River* case.[127] In the commercial setting, losses suffered because of negligent breach of contract, including consequential damages,[128] are insurable.[129] Moreover, where the parties are customarily of comparatively equal bargaining power, contract law provides sufficient protection.[130] This is not necessarily true in a consumer situation. First, consumers typically cannot insure themselves against losses that might result from negligence similar to that which occurred in *Jacques*. Second, the parties do not have equal bargaining power. A consumer applicant is given few rights of negotiation with the lender. For this reason, the consumer's recourse should not be limited to the agreement between the parties.

Moreover, the prior case law denying a duty of care is generally distinguishable from the case at hand. In cases in which a lender was sued for negligently processing a loan application, most courts found no duty of care.[131] In the foremost case attaching negligence liability to the lender, the lender was an active participant in the project to

125. *See supra* note 26.

126. *See* Comment, *Is the Account Good for this Check? Bank Liability for Negligent Responses to Credit Inquiries*, 1983 ANN. REV. OF BANKING LAW 165 (1983) (the special role banks play in the economic system justifies imposition of a high standard of care).

127. East River Steamship Corp. v. Transamerica Delaval, 106 S. Ct. 2295 (1986). See *supra* notes 109-113 and accompanying text for a discussion of the *East River* case with respect to recovery for economic loss.

128. It seems reasonable that consequential damages such as lost profits are more likely to arise in a commercial rather than a consumer setting.

129. *East River*, 106 S. Ct. at 2302.

130. *Id.* at 2303.

131. *See supra* notes 14-25 and accompanying text.

be financed.[132] Arguably, the court imposed liability upon the lender more for his part in the sale of the defective housing units than for his negligence in processing the loan application. All prior cases, however, involved allegations of negligent lending rather than negligent processing per se. In each of the cases rejecting liability, the defendant bank was sued for lending money to the plaintiff for what turned out to be a losing business proposition. All cases rejecting liability arose in the commercial setting.

The *Jacques II* holding illustrates the expansion of the tort cause of action.[133] Conversion of a contract claim into a tort claim is desirable to a plaintiff for several reasons,[134] particularly because it often allows the recovery of significantly increased damages. The damages recoverable in tort are far different than those recoverable in contract. Tort damages are designed to compensate for the injury proximately caused by the defendant's conduct.[135] Alternatively, contract damages are designed to put the plaintiff in the position he would have been in had the contract been performed as promised.[136] This includes compensation for the full benefit of the bargain, including lost profits.[137] Punitive damages are, of course, available in tort actions but not in contract actions. Moreover, there are important limitations upon recovery of contract damages. The contract itself might provide limitations. By and large, such provisions are not enforceable to exculpate the defendant from tort liability, but operate effectively with respect to contract liability.[138] In addition, the rule of *Hadley v. Baxendale*[139] limits the recovery of consequential damages to those damages which were reasonably within the contemplation of the parties at the time of contract formation. Under a tort claim, consequential damages are recoverable as long as they are proximately caused by the negligence. Thus, one might fashion

132. Connor v. Great Western Sav. & Loan Ass'n, 69 Cal. 2d 881, 447 P.2d 609, 73 Cal. Rptr. 369 (1969). *See supra* notes 23-24 and accompanying text.

133. It is this shift that Gilmore explores in his book, THE DEATH OF CONTRACT. G. GILMORE, *supra* note 114.

134. See Perlman, *supra* note 108, at 79-82, and PROSSER & KEETON, *supra* note 64, at 664-667, for a discussion of the differences between tort and contract actions. *See, e.g.*, Kozan v. Comstock, 270 F.2d 839 (5th Cir. 1959) (effect of the statute of limitations upon accrual); United Protective Workers v. Ford Motor Co., 223 F.2d 49 (7th Cir. 1955) (application of the collateral source rule).

135. PROSSER & KEETON, *supra* note 64, at 665.

136. *East River*, 106 S. Ct. at 2303 (1986); Hawkins v. McGee, 84 N.H. 114, 146 A. 641 (1929).

137. *East River*, 106 S. Ct. at 2303; Fuller and Perdue, *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52, 60-63 (1936).

138. PROSSER & KEETON, *supra* note 64, at 665.

139. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

what would otherwise be a contract claim into a tort claim to recover certain consequential damages.[140]

V. Managerial Implications

The *Jacques II* holding is significant and could have far-reaching implications as an expansion of the newly-developing area of lender liability. The *Jacques* decision subjects mortgage lenders to liability for negligent processing of loan applications. Under the court's rationale, lenders face the potential of increased liability under negligence theory,[141] with the duty to exercise reasonable care arising before creation of the debtor-creditor relationship. This potential liability is created even before any loan commitment is issued.[142] The practical implications for lenders are obvious. Lending institutions may reasonably expect lawsuits from applicants who have suffered economic loss because of denial of a loan or a loan of less than the amount requested. The injured applicants may sue either in contract or in tort. Lenders may also reasonably expect a corresponding increase in their tort liability premiums to cover the possibility of such lawsuits.

The potential for lender liability is further increased by the fact that the *Jacques* rationale, although dealing with a residential mortgage loan application, is equally applicable to other loan applications. The rationale applies equally to loan applications for the consumer purchase of a boat, a car, a major appliance, or to a personal loan application.[143] A lawsuit might result from a mistaken or wrongful denial of *any* loan application where the applicant suffers economic loss as a result. First, all loan applications, once accepted for processing by the lender, should be considered contracts. When a lender holds itself out to the public as a source of loans based on predetermined eligibility standards, the lender implicitly promises to make loans to qualified applicants in the amount, at the rate, and for the term advertised, regardless of whether the loan is for consumer or commercial purposes and regardless of whether the loan application requires a fee. The business opportunity created by the appli-

140. Consequential damages that were not reasonably within the contemplation of the parties at the time of contract formation could be recovered under a tort theory.

141. Negligence has thus far been applicable in the lender-borrower situation only where the lender exerts a substantial degree of control over the borrower. *See supra* notes 20-25 and accompanying text.

142. Liability had been previously imposed for lack of good faith in a commitment letter situation. *See supra* note 30 and accompanying text.

143. Unless a distinction is made between consumer and commercial loan transactions, as suggested in this article, the rationale would apply equally to any business loan application.

cant's submission is sufficient consideration to support the lender's express and implied promises. Second, the rationale for imposing tort liability is equally applicable to other loan application contexts. The risk of liability is, therefore, increased by the *Jacques* ruling in all loan application situations.

One defense to a complaint is the lender's compliance with the standard of care; in other words, the specific loan was processed and the eligibility determination made in accordance with the lender's policies and procedures. Given the large number of loan applications accepted and processed, however, there seems to be a statistical inevitability that something more is needed than the admonition: "Be careful! Double check everything! Notify promptly! Review!"

One suggested measure against both a negligence claim and a breach of contract claim is an exculpatory provision[144] included on the lending institution's loan application form. Maryland law allows parties to expressly agree in advance that the defendant is under no obligation of care for the benefit of the plaintiff and that he shall not be liable for the consequences of conduct which would otherwise be negligent.[145] There are, however, two exceptions to this general rule which might render an exculpatory provision invalid. First, an exculpatory clause is invalid if the relationship of the parties is such that one party is at an obvious disadvantage in bargaining and the exculpatory clause effectively puts him at the mercy of the other's negligence. If all lenders adopt the same exculpatory provisions, this would create an adhesion contract and raise a question of unconscionability. One way to avoid this situation would be to offer the loan applicant a choice of either signing the application with the clause or paying an additional fee with an application without the clause.[146] Those who could not afford the additional fee could, however, argue that they had no real choice and that the clause should not be enforced.

The second exception invalidates exculpatory provisions if they are part of a transaction affected with a public interest. *Winterstein*

144. An exculpatory provision is an express waiver by the applicant of the right to sue the lender in the event of negligent processing or a negligent eligibility determination.

145. Winterstein v. Wilcom, 16 Md. App. 130, 293 A.2d 821 (1972), held that an exculpatory agreement in connection with use of a drag strip operated by defendant was not void as against public policy.

146. In Boucher v. Riner, 68 Md. App. 539, 514 A.2d 485 (1986), a parachuting student sued the instructor and the parachute school. The court held that the student was not compelled to agree to waive his right to sue for negligence, since he had the option to pay an additional fee if he chose not to waive his right to sue in the event of an accident involving the negligence of the defendants.

v. Wilcom[147] identified the factors to be considered in determining whether a transaction is so affected by public interest as to invalidate exculpatory provisions. Applying these factors[148] to the case at hand, it is clear that the process of lending money has some of these characteristics. It is a business subject to regulation. It provides a service of great importance to the public and is a matter of practical necessity for the vast majority of the public. Few people are in a position to pay the complete cash price for their homes, cars, major appliances, or even their clothes. Lenders hold themselves out as willing to loan to any qualified member of the public. The lender certainly has a bargaining advantage over any member of the public seeking the lender's services. The lender may or may not use a standardized adhesion contract of exculpation and provide the option of paying an additional reasonable fee to purchase protection against the lender's negligence. It seems, therefore, that at least in consumer and residential mortgage loan application situations, the use of an exculpatory clause is probably unenforceable.

VI. Conclusion

Implications for lenders from the *Jacques* case are self-evident. To avoid liability, some care should be taken before a lender undertakes to accept a loan application. Great care also should be taken in processing the application, especially in documenting any reasons for rejection or reservation. Since lenders are generally free to extend credit to whomever they wish, rejections might be better justified upon more subjective criteria. Again, documentation of these subjec-

147. 16 Md. App. 130, 293 A.2d 821 (1972).

148. The court lists the factors as follows:

> [T]he attempted but invalid exemption involves a transaction which exhibits some of or all of the following characteristics. It concerns a business of a type generally thought suitable for public regulation. The party seeking exculpation is engaged in performing a service of great importance to the public, which is often a matter of practical necessity for some members of the public. The party holds himself out as willing to perform this service for any member of the public who seeks it, or at least for any member coming within certain established standards. As a result of the essential nature of the service, in the economic setting of the transaction, the party invoking exculpation possesses a decisive advantage of bargaining strength against any member of the public who seeks his services. In exercising a superior bargaining power the party confronts the public with a standardized adhesion contract of exculpation, and makes no provision whereby a purchaser may pay additional reasonable fees and obtain protection against negligence. Finally, as a result of the transaction, the person or property of the purchaser is placed under the control of the seller, subject to the risk of carelessness by the seller or his agents.

Id. at 137, *quoting* Tunkl v. Regents of Univ. of Calif., 60 Cal.2d 92, 98-101, 383 P.2d 441, 445-46, 32 Cal. Rptr. 33, 37-38 (1963).

tive considerations is crucial. The potential for increased fees to cover increased processing and insurance costs is likely.