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Written Agreements in the Lender-Borrower Context: The Illusion of Certainty

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I. INTRODUCTION

Recent legal battles in the lender-borrower arena have received widespread attention. The fact that these battles occur merits little surprise because borrowers often seek recourse against lenders when financial commitments go awry. Moreover, recent lender-borrower cases do not introduce any new legal theories. The outcome is the noteworthy feature of these cases. Borrowers increasingly are obtaining judgments against lenders.

This Note examines recent lender-borrower cases from a contractual perspective, analyzing the application of traditional contract principles in the lender-borrower context. Part II of this Note contends that

* Throughout the Special Project, this piece is cited as Special Project Note, *Written Agreements.*

courts are trying to address three concerns in the lender-borrower context: maintenance of banking stability through enforcement of written contracts, avoidance of adhesion contracts, and provision of legal recourse to borrowers against abusive lending practices. Part III considers several state legislatures' attempts to deal with these concerns by amending their Statutes of Frauds. Finally, Part IV concludes that the state legislatures' use of the Statutes of Frauds better addresses the concerns of banking stability, adhesion contracts, and abusive lending practices than recent judicial efforts.

II. Effectiveness of a Writing

A. *Actions Prior to a Written Agreement*

1. Parol Evidence Rule

a. *Overview*

Once a contract is reduced to writing, courts favor the written document over all other evidence in interpreting the parties' intent. The parol evidence rule, which ensures that the court will defer to the written agreement, is intended to promote business stability by aspiring to give legal effect to the parties' intent to make their writing a final and complete expression of their agreement.[1] If the written contract is intended to be complete, it is termed "integrated," and the parol evidence rule may prohibit evidence of prior or contemporaneous negotiations.[2] If the contract is not intended to be a complete expression, it is termed "unintegrated," and the parol evidence rule does not apply.[3]

If the written agreement is considered integrated it must be examined further to determine whether this integration is partial or complete. The difference between a partially or completely integrated contract depends on the degree to which the parties intended the written document to express their agreement. A partially integrated agreement constitutes a final expression of the terms it addresses, but not a complete expression of all the agreed upon terms. A completely integrated agreement represents a final and complete expression of all the terms on which the parties agreed.[4]

If an agreement is completely integrated, the parol evidence rule bars evidence of prior or contemporaneous agreements that contradict

1. E. Farnsworth, Contracts § 7.3, at 451 (1982).
2. *Id.* Admittance of this evidence depends on the degree of integration and whether the evidence supplements or contradicts the written agreement. *Id.*
3. *Id.*
4. *Id.* § 7.3, at 452.

or supplement a term in the contract.[5] Partial integration, however, allows evidence of prior or contemporaneous agreements to supplement the terms of the contract, but not to contradict them.[6] Thus, once attached, these labels determine how the parol evidence rule will affect a particular document.

b. Approaches Used to Determine Applicability of the Parol Evidence Rule

The process used to attach these labels varies among courts. In general, a broad range of evidence, including evidence of prior negotiations, may be used to determine whether a written agreement is integrated.[7] Once a court determines that the contract is integrated, a variety of approaches is used to determine whether the integration is partial or complete. The approach taken by the court to decide the partial or complete integration question is important because this approach will determine the scope of the parol evidence rule.

One approach taken by courts focuses solely on the terms of the written agreement. This approach, called the "four-corners" test, allows parol evidence only if the document appears incomplete on its face.[8] Hence, under this approach a court may inspect only the writing in order to determine the parties' intent concerning complete integration. Although commentators have observed a softening of this test,[9] the four-corners approach clearly shows great deference to the intent of the parties as expressed in the written agreement.

Sedalia Mercantile Bank & Trust Co. v. Loges Farms, Inc.[10] illustrates the four-corners approach. *Loges Farms* involved a restructuring of the defendant's debt by the plaintiff-bank. Part of the documentation for this transaction included a "loan agreement," which stated that the defendant must furnish complete and accurate financial data to the bank. The defendant, however, was unable to make payments under this restructured agreement, so the parties agreed on written modifica-

5. RESTATEMENT (SECOND) OF CONTRACTS § 215 (1981) [hereinafter RESTATEMENT OF CONTRACTS]; *see also* U.C.C. § 2-202 (1987) (containing similar language).

6. RESTATEMENT OF CONTRACTS, *supra* note 5, §§ 210(2), 215, 216. Again the U.C.C. language is similar. *See* U.C.C. § 2-202 (1987).

7. RESTATEMENT OF CONTRACTS, *supra* note 5, § 209(3) (stating that a reasonably complete written agreement is considered an integrated agreement "unless it is established by other evidence that the writing did not constitute a final expression"); E. FARNSWORTH, *supra* note 1, § 7.3, at 453.

8. *See* E. FARNSWORTH, *supra* note 1, § 7.3, at 455.

9. Farnsworth notes that some courts consider a strict four-corners reading to be useless in determining the degree of integration. These courts allow parties to introduce some of the surrounding circumstances, but exclude any evidence of prior negotiations. *Id.* § 7.3, at 456.

10. 740 S.W.2d 188 (Mo. Ct. App. 1987).

tions extending the due dates. The defendant also failed to provide complete financial data by neglecting to inform the bank of an outstanding loan. The bank considered this omission a breach of the loan agreement and called the notes due. The defendant, however, argued that the modification agreements were fully integrated. Thus, because the loan agreement was not mentioned in the subsequent agreements, the parol evidence rule barred its admittance as part of the contract. Without the loan agreement, no breach of contract existed.[11]

The Missouri appellate court, basing its decision on the language of the modification agreements, held that the modification agreements were fully integrated.[12] These modification agreements made reference to other documents executed at the time of the restructuring of debt and, thus, incorporated them into the parties' loan agreement. The loan agreement, however, was not mentioned. The court, therefore, refused to admit the loan agreement, because it would have added to the terms of a fully integrated agreement.[13]

Despite cases like *Loges Farms*, the trend has been away from the four-corners test and toward approaches that more liberally admit the contested evidence. Professor Samuel Williston has promulgated a more liberal approach that has become the majority rule in this country.[14] Like the four-corners test, this approach first focuses on the writing itself. If the writing is obviously incomplete, then parol evidence may be admitted to prove consistent additional terms. If the writing is not obviously incomplete, then it is deemed completely integrated, unless the additional terms naturally might have been made in a separate agreement. In such a case, the agreement is considered partially integrated.[15] By considering what might be made "naturally" as a separate agreement, this test does not focus on the actual intent of the contracting parties but on the fictitious intent of a reasonable person.[16] This reasonable person approach, therefore, provides some latitude to courts in deciding the issue of integration.

Bank of Beverly Hills v. Catain[17] illustrates the application of this approach in the lender-borrower context. On March 28, 1978, the defendant borrowed forty thousand dollars from the plaintiff-bank, executing a promissory note which stated that the note was due on

11. *Id.* at 193.
12. *Id.*
13. *Id.* at 194.
14. 4 S. WILLISTON, CONTRACTS §§ 633-644 (3d ed. 1961).
15. *See* J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 3-4, at 147-48 (3d ed. 1987).
16. *Id.* at 148.
17. 128 Cal. App. 3d 28, 180 Cal. Rptr. 67 (1982).

demand, or, if no demand was made, on September 20, 1978.[18] The bank made no demand prior to September 20, and the defendant failed to pay on this date. The plaintiff-bank subsequently brought suit to recover on the note. The defendant alleged that the plaintiff-bank had represented that on maturity a repayment schedule would be implemented and the terms of the note renegotiated. The lower court granted summary judgment for the plaintiff, and the defendant moved for reconsideration.[19] In support of the reconsideration motion, the defendant introduced the declaration of the loan officer who had negotiated the loan and the "loan approval sheet," dated March 16, 1978. Both pieces of evidence supported the defendant's allegation. A California district court, however, denied reconsideration because this evidence related to incidents occurring prior to the execution of the written agreement.[20]

A California appellate court reversed the lower court's decision. The appellate court noted initially that summary judgment was proper only if the documents relied on by the defendant were inadmissible evidence under the California parol evidence rule.[21] The court then applied a two-pronged test to determine the admissibility of the evidence.[22] This test evaluated the credibility of the proffered evidence and excluded it only if such evidence would be likely to mislead the fact finder.[23] The first prong looked at the collateral agreement to determine it if was the type of agreement that parties in this situation naturally would make by a separate agreement.[24] Answering affirmatively, the court stated that if the loan officer's declaration was credible, then it

18. *Id.* at 30, 180 Cal. Rptr. at 69.

19. *Id.* at 33, 180 Cal. Rptr. at 70.

20. *Id.* at 32, 180 Cal. Rptr. at 70.

21. *Id.* at 34, 180 Cal. Rptr. at 70.

22. *Catain*, 128 Cal. App. 3d at 35, 180 Cal. Rptr. at 71. The California Supreme Court created this test in Masterson v. Sine, 68 Cal. 2d 222, 436 P.2d 561, 65 Cal. Rptr. 545 (1968). Several sources guided the California Supreme Court: First, the *Restatement (Second) of Contracts* § 240(1)(b), allowing proof of a collateral agreement if it "might *naturally* be made as a separate agreement by parties situated as were the parties to the written contract," RESTATEMENT OF CONTRACTS, *supra* note 5, § 240(1)(b) (emphasis added), and second, *U.C.C.* § 2-202, allowing even more parol evidence by permitting admittance of evidence in a case if it does not represent terms that "would *certainly*" have been in the written agreement, U.C.C. § 2-202 official comment 3 (1987) (emphasis added).

23. *Catain*, 128 Cal. App. 3d at 35, 180 Cal. Rptr. at 71.

24. *Id.* at 37, 180 Cal. Rptr. at 72. This test must be distinguished from the collateral contract rule, which allows for collateral agreements even upon finding the document to be completely integrated, so long as the collateral agreements do not contradict the main agreement. An entirely separate and distinct agreement may be made by the parties, even though the consideration for this agreement flows from the main agreement. As Farnsworth points out, what is really being decided in these cases is that the agreement is partially integrated. E. FARNSWORTH, *supra* note 1, § 7.3, at 459.

would be appropriate to determine a repayment schedule in a separate agreement.[25]

The second prong looked at the collateral agreement to determine if that agreement normally would be incorporated in the written agreement.[26] The *Catain* court held that this agreement properly would be left to the bank's records because this type of agreement could impair the negotiability of the note if disclosed on the note itself.[27] Analyzed under this two-pronged test, therefore, the proffered evidence was not likely to mislead a fact finder and should have been admitted. Thus, the court allowed the additional term, renegotiation of the manner of repayment, to supplement the note[28] because the additional term did not contradict any expressed provisions of the written agreement.

In determining that this agreement supplemented the promissory note, the *Catain* court distinguished two prior cases.[29] In these cases the borrowing party argued that it did not owe money to the bank. Both courts held that the parol evidence rule barred this argument because it contradicted an integrated contract. In *Catain*, however, the borrowing party admitted its debt and only contested the manner of payment. A term calling for renegotiation of the manner of payment, the *Catain* court reasoned, was not contradictory to the terms of the promissory note, which required payment in full on a specific date. Such tenuous reasoning, while keeping the parol evidence rule theoretically intact, diminishes the rule's application.

The most liberal approach, proposed by Professor Arthur Corbin,[30] rejects the reasonable person approach and seeks to ascertain the actual

25. *Catain*, 128 Cal. App. 3d at 37, 180 Cal. Rptr. at 72.

26. *Id.* at 37, 180 Cal. Rptr. at 72-73.

27. *Id.* at 37, 180 Cal. Rptr. at 73.

28. *Id.* at 36, 180 Cal. Rptr. at 72. The court appears to have combined the analysis for determining whether a written agreement is integrated and differentiating between a partially and completely integrated document. According to Farnsworth, the parol evidence rule applies only if a writing is integrated. E. FARNSWORTH, *supra* note 1, § 7.3, at 456. Thus, only integrated writings cannot be contradicted by extrinsic evidence. The *Catain* court stated that this two-pronged test determined the question of integration. This test, however, is not intended to destroy the parol evidence rule by allowing extrinsic evidence to contradict an express term of the written agreement. If the test addresses the initial question of integration, then extrinsic evidence contradicting an expressed term is allowable upon a finding of nonintegration. The parol evidence rule is not weakened because the rule is inapplicable. If the test precludes evidence contradicting an expressed term of the written agreement and permits evidence of a collateral or additional term, it essentially is determining whether the agreement is partially integrated. Thus, the test already assumes the existence of an integrated agreement. Hence, although a court may label this a test to determine integration, its practical effect is to distinguish partially integrated documents from completely integrated ones.

29. Coast Bank v. Holmes, 19 Cal. App. 3d 581, 97 Cal. Rptr. 30 (1971); Sapin v. Security First Nat'l Bank, 243 Cal. App. 2d 201, 52 Cal. Rptr. 254 (1966).

30. 3 A. CORBIN, CORBIN ON CONTRACTS § 582, at 444 (1960).

intent of the contracting parties. To accomplish this task, this approach requires a court to examine all of the circumstances surrounding an agreement, including evidence of prior negotiations. Corbin's approach allows a court to admit the very evidence being challenged to determine the question of total integration.[31] Proponents argue that the completeness of a particular writing can be determined only in light of all the circumstances.[32] Such an approach, however, undercuts the purpose of the parol evidence rule.

Corbin's and Williston's approaches to determine the existence of integration dilute both the parol evidence rule itself and written contracts in general. In the lender-borrower context, the weakening of the parol evidence rule favors borrowers because loan agreements typically are standardized forms drafted by the bank and may not encompass the entire scope of the parties' agreement. Borrowers often have little power to change the terms of these written agreements.[33] Admitting parol evidence permits a court to investigate the intent of the parties fully.

Thus, Corbin's and Williston's approaches provide courts with the latitude to avoid enforcement of adhesion contracts. These approaches, however, undermine the stability of the banking industry. Banks make numerous loans each day and must be able to rely upon the enforceability of the documents executed in conjunction with these loans. Given this tension, it is not surprising to find that courts are attempting to maintain stability in the banking industry despite the erosion of the parol evidence rule.

2. Merger and Disclaimer Clauses

One contractual method of providing stability to the contracting parties is a merger clause. A merger clause states that the agreement is completely integrated, thereby merging prior negotiations into the writing.[34] Courts often uphold merger clauses as conclusive in determining the question of complete integration.[35] Notwithstanding the presence of

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31. J. CALAMARI & J. PERILLO, *supra* note 15, § 3-4, at 149.

32. E. FARNSWORTH, *supra* note 1, § 7.3, at 456. The commentary to § 210 of the *Restatement (Second) of Contracts* states that "a writing cannot of itself prove its own completeness, and wide latitude must be allowed for inquiry into circumstances hearing on the intention of the parties." RESTATEMENT OF CONTRACTS, *supra* note 5, § 210 comment b.

33. A recent article, pointing out the plight of the "powerless" borrowers against "arrogant bankers," described an exchange that allegedly took place between two parties. The borrower, convinced that the bank was not processing its loan diligently, complained that the bank was not acting in good faith. The bank officer's response: "Screw good faith. We're going to do it our way." Bailey, *Banks Hit by Borrowers' Liability Suits*, Wall St. J., June 2, 1988, § 2, at 3, col. 6.

34. J. CALAMARI & J. PERILLO, *supra* note 15, § 3-6, at 156.

35. *See, e.g.*, Braten v. Bankers Trust Co., 60 N.Y.2d 155, 162, 456 N.E.2d 802, 805, 468

a merger clause, some causes of action will allow courts to admit parol evidence.[36] Courts, however, attempting to further stability, have relied on "disclaimer clauses" in contracts to foreclose the admittance of parol evidence even in some of these circumstances.

Citibank v. Plapinger[37] demonstrates how a disclaimer clause in a written guaranty may disallow parol evidence even when the borrowing party claims fraudulent misrepresentation as a defense. In *Plapinger* the plaintiff-banks restructured the defendant's indebtedness into a 15.2 million dollar term loan guaranteed by the defendant. The defendant alleged that neither he nor the other shareholders would agree to sign the commitment letter for this restructuring unless the plaintiff-banks agreed to establish an additional eight million dollar line of credit. The plaintiff-banks, according to the defendant, agreed to this request.[38] The defendant executed an unconditional guaranty that contained a merger clause and a disclaimer clause. The disclaimer clause stated that the borrower was not executing the guaranty in reliance on any oral representations made by the lender.[39].

The line of credit never materialized, and the defendant subsequently filed for bankruptcy. The plaintiff-banks sued to recover on the guaranty. The defendant's answer set up several defenses, including fraudulent inducement, and counterclaimed based on fraud, negligent misrepresentation, and breach of contract. A New York trial court granted judgment for the plaintiff-banks, holding that the defendant expressly had waived his right to assert the defenses and counterclaims as part of the unconditional guaranty.[40]

The New York Court of Appeals affirmed the trial court's decision, relying specifically on the disclaimer clause. The court stated that the defendant had strong evidence of fraud, but because the disclaimer language was so specific the court foreclosed, as a matter of law, the claims

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N.Y.S.2d 861, 864 (1983) (stating that a court must look to surrounding circumstances to determine integration only in absence of a merger clause); *see also* Centerre Bank v. Distributors, Inc., 705 S.W.2d 42, 51 (Mo. Ct. App. 1985) (holding that a guaranty was completely integrated because it stated that "there are no conditions or limitations to this guaranty except those written or printed herein, and no alteration, change, or modification shall be made except in writing").

36. These causes of action include evidence to show that the entire contract was to be a nullity, and not that certain provisions were unenforceable; that a condition precedent did exist; that consideration was lacking; or that the contract was voidable due to mistake, misrepresentation, or duress. E. FARNSWORTH, *supra* note 1, § 7.4, at 461-67; *see also* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (stating that whether the standard for waiver of the right to a jury trial had been met was a constitutional question, which precluded the operation of parol evidence rule to bar extrinsic evidence bearing on this question).

37. 66 N.Y.2d 90, 485 N.E.2d 974, 495 N.Y.S.2d 309 (1985).

38. *Id.* at 93, 485 N.E.2d at 975, 495 N.Y.S.2d at 310.

39. *Id.* at 95, 485 N.E.2d at 977, 495 N.Y.S.2d at 312.

40. *Id.* at 92, 485 N.E.2d at 975, 495 N.Y.S.2d at 310.

based on fraud.[41] The court held that the language of the contract barred the defendant from establishing reliance on the oral promise allegedly made by the plaintiff-banks.[42] According to the *Plapinger* court, allowing the defendant to show fraud despite his own specific disclaimer of reliance on oral representations would make the defendant guilty of deliberately misrepresenting his real intentions.[43]

The court distinguished language used to create general merger clauses from language used to create specific disclaimer clauses.[44] Merger clauses, unlike disclaimer clauses, will not preclude the admittance of parol evidence to establish a claim of fraudulent inducement. Such a distinction, of course, causes a careful draftsman to employ both merger and disclaimer clauses. For this reason critics argue that the *Plapinger* court's holding encourages the use of boilerplate language and more verbose merger clauses.[45] Responding to this criticism, the *Plapinger* court pointed out that this disclaimer clause was not boilerplate, but arose from lengthy negotiations between sophisticated business people who put together a multimillion dollar personal guaranty declared by the defendant to be absolute and unconditional.[46] Thus, after *Plapinger*, a prudent draftsman should take steps to distinguish a disclaimer clause from mere boilerplate language.

The Texas Supreme Court, in *Town North National Bank v.*

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41. *Id.* at 93, 485 N.E.2d at 975, 495 N.Y.S.2d at 310.

42. *Id.* at 95, 485 N.E.2d at 977, 495 N.Y.S.2d at 312.

43. *Id.*

44. *Id.* at 94, 485 N.E.2d at 976, 495 N.Y.S.2d at 311; *accord* Fogel v. Lenox Hill Hosp., 127 A.D.2d 548, 512 N.Y.S.2d 109 (App. Div. 1987) (holding that a general merger clause would not preclude evidence of fraudulent inducement). A waiver clause, in which a party waives his right to assert certain counterclaims and defenses, is equally ineffective. National Westminster Bank v. Ross, 676 F. Supp. 48 (S.D.N.Y. 1987) (stating that a written waiver in any form cannot shield a party from his own fraud).

45. *See* J. CALAMARI & J. PERILLO, *supra* note 15, § 9-21, at 371-72. These authors recommend making a distinction between negotiated clauses and standard form clauses, rather than the current distinction between merger and disclaimer clauses. This recommendation seeks to further the borrower's ability to negotiate terms and not be bound by boilerplate terms that approach the level of an adhesion contract.

46. Although the *Plapinger* court did not mention this, public policy concerns advocate upholding these clauses. In Franklin Nat'l Bank v. Skeist, 49 A.D.2d 215, 373 N.Y.S.2d 869 (App. Div. 1975), the court noted:

> The stability of banks is a matter of such public concern that the state or federal government regulates the affairs of each bank and periodically examines its apparent condition. The state cannot sanction any device intended to give a false appearance to a transaction or increase the apparent stability of a bank. . . . Public policy requires that a person who, for the accommodation of the bank, executes an instrument which is in form a binding obligation, should be estopped from thereafter asserting that simultaneously the parties agreed that the instrument should not be enforced.

Id. at 219-20, 373 N.Y.S.2d at 874 (quoting Mount Vernon Trust Co. v. Bergoff, 272 N.Y. 192, 196, 5 N.E.2d 196, 197 (1936)). The desire to avoid the use of boilerplate, or not bargained-for, language may be outweighed by the public policy concerns for a stable banking industry.

Broaddus,[47] promulgated a parol evidence rule similar to, but less restrictive than, the parol evidence rule set forth by the New York court in *Plapinger*. The *Broaddus* court stated that parol evidence only will be allowed to prove fraud in the inducement of a note when a party shows some type of trickery, artifice, or device used by the payee and alleges that the payee promised that the maker would not be liable on such a note.[48] Thus, according to the *Broaddus* court, a party cannot base its claim of fraudulent inducement solely on allegations of an oral promise.[49]

The *Broaddus* court gave several examples of the additional proof necessary to preclude application of the parol evidence rule. One example cited by the court was *Berry v. Abilene Savings Association*,[50] in which a borrower, who was unable to borrow funds himself, conspired with a loan officer to have a third party sign the note and receive the loan proceeds. The loan officer assured the third party signing the note that he would not be liable on the note. This inducement of nonliability to the third party in order to achieve financing for the original borrower constituted a fraudulent device.[51] Another case cited by the *Broaddus* court, *Viracola v. Dallas International Bank*,[52] involved a bank that requested a corporate president to co-sign a note and to pledge his stock in the corporation in order for the corporation to obtain a loan to support its operations. At the time of the loan, the president was involved in negotiations for the company's sale, and the bank assured the president that his co-signing the note and pledging his stock were only to guarantee payment from the proceeds of the sale. The bank further assured the president that in the event the sale was not consummated his personal liability would end.[53] The bank subsequently attempted to enforce this note despite the failure of the sale. The *Viracola* court stated that this situation constituted a fraudulent device.[54]

The *Broaddus* court noted, however, that the facts in *Lindeburg v. Gulfway National Bank*[55] did not amount to a deceptive scheme. In *Lindeburg* a bank officer told a loan customer that the bank officer had a no-risk deal but lacked cash. The bank officer suggested that the customer take out a bank loan, which this officer would approve, and then

47. 569 S.W.2d 489 (Tex. 1978).
48. *Id.* at 494.
49. *Id.* at 492.
50. 513 S.W.2d 872 (Tex. Civ. App. 1974).
51. *Id.* at 874.
52. 508 S.W.2d 472 (Tex. Civ. App. 1974).
53. *Id.* at 473.
54. *Id.* at 474.
55. 624 S.W.2d 278 (Tex. Ct. App. 1981); *see also* Bailey v. Gulfway Nat'l Bank, 626 S.W.2d 70 (Tex. Ct. App. 1981).

give the proceeds of the loan to the bank officer. The officer then would execute a note in favor of the customer for that amount. The customer agreed and the transactions were completed. Shortly thereafter, the bank officer disappeared and the bank brought action against the customer on the note that he had executed in favor of the bank. The court held that no deceptive scheme was employed because the defendant was interested simply in improving his own borrowing power and helping a friend, the loan officer, by borrowing funds from the bank.[56]

None of these examples clearly defines what constitutes trickery or a fraudulent device. Given these examples and little commentary by the court, it is difficult to determine the parameters of the *Broaddus* rule. Certainly this parol evidence rule provides courts with a clean conceptual test to determine the admissibility of parol evidence; but it provides little practical guidance as to its application. At the very least, the *Broaddus* parol evidence rule will ensure that parties plead and argue the claim of fraudulent inducement with enough factual specificity to facilitate a finding of a deceptive scheme and, thus, to allow parol evidence to be introduced.

The *Plapinger* and *Broaddus* holdings demonstrate the extent to which some courts will go to maintain stability in the banking industry despite the demise of the parol evidence rule. On the one hand, these courts feared that any party, by claiming fraud, could introduce extrinsic evidence that contradicted the written agreement. The practical effect of allowing this extrinsic evidence to be introduced would be to destroy the parol evidence rule and reduce promissory notes to a " 'meaningless scrap of paper.' "[57] On the other hand, both courts recognized that a fraudulently induced document does not express the intent of the parties, and the only way to prove the parties' intent is by admitting parol evidence. Thus, the *Broaddus* court sought to balance these two concerns by admitting parol evidence if a party can prove that he fraudulently was induced into signing a note through a deceptive artifice or device. The *Plapinger* court, however, overcompensated in favor of banking stability by foreclosing any opportunity to admit parol evidence proving fraudulent inducement in certain circumstances.

Although the parol evidence rule helps to maintain banking stability by protecting the integrity of written agreements, it is limited because it only excludes evidence of prior or contemporaneous negotiations. The parol evidence rule does not affect evidence of actions or promises occurring after the execution of the written agreement.

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56. *Lindeburg*, 624 S.W.2d at 281.

57. *Broaddus*, 569 S.W.2d at 492 (quoting Howeth v. Davenport, 311 S.W.2d 480, 482 (Tex. Civ. App. 1958)).

B. *Actions Subsequent to a Written Agreement*

An agreement defines the actions expected of each party and dispenses certain powers and rights. In this respect, an agreement is prescriptive in nature and influences the parties' actions.[58] Subsequent action, however, also can influence the nature and terms of the original agreement. Thus, a party should view a potential act from at least two perspectives: how an agreement defines the particular act, and how that act might modify the written agreement.

1. Modification of Written Agreements

a. *Overview*

A written agreement can be modified orally by the parties, but such a modification may require adequate consideration[59] and may be subject to the Statute of Frauds.[60] Mutual agreements to modify a written agreement may be express, but also can be inferred from the parties' conduct and the surrounding circumstances.[61]

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58. Of course, the law can impose duties upon contracting parties that extend beyond the terms of the agreement. As a result, several courts have dealt with lender-borrower cases by focusing on the lender-borrower relationship rather than on the written agreements. In particular, some courts have classified the lender-borrower relationship as one of trust and confidence, finding certain duties based on this classification. Most courts, however, require special circumstances to create something more than a mere lender-borrower relationship. *See, e.g.,* Klein v. First Edina Nat'l Bank, 293 Minn. 418, 196 N.W.2d 619 (1972) (stating that a bank has no special duty to its customers unless special circumstances exist). Several courts, on the other hand, have set a low standard to create such a relationship. *See, e.g.,* Barrett v. Bank of Am., 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16 (1986) (holding that the horrower perceived his relationship with the lender as being close and, therefore, implicitly relied on the lender's advice); First Nat'l Bank v. Brown, 181 N.W.2d 178 (Iowa 1970) (holding that the lender had a duty to disclose because he knew or should have known that the borrower trusted him implicitly); *see also* Special Project Note, *Lender Liability, supra,* at notes 64-134 and accompanying text.

59. The pre-existing duty rule requires a modification to have consideration separate from the original agreement. Thus, a promisee, receiving a promise to modify an agreement, cannot promise simply to perform a pre-existing duty created by the previous agreement. This rule has been subjected to criticism and legislative change. *See* U.C.C. § 2-209(1) (1987) (abolishing the consideration requirement). Some states circumvent the rule by making a signed writing a substitute for consideration. *See, e.g.,* MICH. COMP. LAWS ANN. § 566.1 (West Supp. 1988); N.Y. GEN. OBLIG. LAW § 5-1103 (McKinney Supp. 1988). Yet courts still apply this rule in the lender-borrower context. *See, e.g.,* F.S. Credit Corp. v. Shear Elevator, Inc., 377 N.W.2d 227 (Iowa 1985) (holding that an additional extension of credit was adequate consideration to modify security agreement); First Pa. Mortgage Trust v. Dorchester Sav. Bank, 395 Mass. 614, 481 N.E.2d 1132 (1982) (holding that an oral modification of a loan participation agreement was supported by adequate consideration); South Carolina Nat'l Bank v. Silks, 295 S.C. 107, 367 S.E.2d 421 (Ct. App. 1988) (stating that an oral modification of a promissory note needed to be supported by consideration).

60. The Statute of Frauds only applies if the modification itself falls within the Statute of Frauds, notwithstanding that the original agreement was within the Statute of Frauds. E. FARNSWORTH, *supra* note 1, § 6.2, at 377.

61. *Silks,* 295 S.C. at 108, 367 S.E.2d at 422; *see also* E. FARNSWORTH, *supra* note 1, § 7.5, at

Contracting parties cannot prevent modifications through "no-oral-modification" clauses. Common law generally refuses to recognize these clauses.[62] Some states have changed this common-law rule by enacting statutes that enforce "no oral modification" clauses. New York, for example, upholds such clauses unless the modification or termination is in writing and signed by the party against whom enforcement is sought.[63] The New York statute, however, allows evidence of an oral modification if the party seeking the statutory protection is estopped from disclaiming the modification or the other party has acted in reliance on the modification.[64] Given these two exceptions, the New York statute affects only executory oral agreements.[65]

In states that have not adopted statutes recognizing "no oral modification" clauses, the common-law rule offers little protection for parties seeking to prevent modification. Yet, the quality of proof necessary to modify an agreement does afford some protection. Generally, the proof must be specific enough to show that the parties clearly intended to change their written agreement.[66] This safeguard, however, provides little guidance for a lender in its daily activities because courts have held that the "persuasive character" of the evidence need not be express and may arise inferentially.[67]

The danger of modification often arises when the lender and borrower renegotiate a loan agreement. In this situation the borrower typically finds himself in financial difficulty, and the lender is trying to protect the initial loan by agreeing to provide further financing, or by rescheduling the payments if the borrower promises to repay. Impressions created during these negotiations often may affect the lender's rights adversely should these negotiations turn sour.

474-76.

62. *Dorchester Sav. Bank,* 395 Mass. at 614, 481 N.E.2d at 1132.

63. N.Y. GEN. OBLIG. LAW § 15-301 (McKinney Supp. 1988); *see also* CAL. CIV. CODE § 1698 (West 1985); U.C.C. § 2-209(2) (1987).

64. *See In re* Global Int'l Airways, 35 Bankr. 881 (Bankr. W.D. Mo. 1983).

65. This statute seeks to protect a written agreement from false claims of modification. When there has been partial or complete performance of an oral modification, the need for such protection is lessened. Yet this partial performance will result in modification only if it refers unequivocally to the oral modification. National Westminster Bank v. Ross, 676 F. Supp. 48 (S.D.N.Y. 1987). Substantial reliance on an oral modification may also trigger the statute's applicability. The party seeking recognition of the modification must rely on conduct incompatible with the agreement as written. *Id.* at 53 (assurances of increased financing were incompatible because they were not in any of the written agreements).

66. *See* Hamilton Bank v. Rulnick, 327 Pa. Super. 133, 138, 475 A.2d 134, 137 (1984). The *Rulnick* court noted: " 'The oral evidence must be of such a persuasive character that it moves like an ink eradicator across the written paper, leaving it blank so that the parties in effect start afresh in their . . . mutual commitments.' " *Id.* (quoting Gloeckner v. Baldwin Township School Dist., 405 Pa. 197, 200, 175 A.2d 73, 75 (1961)).

67. *See, e.g., id.*

b. Judicial Responses to Subsequent Negotiations

Alaska Statebank v. Fairco[68] demonstrates the potential impact of negotiations subsequent to the execution of a written agreement in the lender-borrower context.[69] In *Fairco* the plaintiff, Fairco, borrowed one hundred twenty thousand dollars in February 1977, and fifty thousand dollars in February 1978 from the defendant-bank, executing a security agreement each time. The security agreement for the fifty thousand dollar note contained a provision that allowed the bank to accelerate all indebtedness without notice if Fairco defaulted under any of the loan provisions. The security agreement also provided for payment on demand or in installments.[70] Fairco missed the first installment payment, and both parties agreed that this amount would be paid on December 15, 1978, when the entire balance was due. The written security agreement was amended to reflect this understanding.[71] Fairco then failed to make payments on the next two installment dates. A bank officer's investigation revealed that Fairco was in serious financial trouble, having insufficient income to pay debts as they became due and no original equity because of operating losses. On October 16, the bank officer met with the partners of Fairco to discuss this situation. Fairco wanted to delay repayment of the notes until after Christmas but the officer refused. On November 3, 1978, a proposal was sent to Fairco agreeing to grant the requested extension if the partners of Fairco would provide the bank with deeds of trust on their personal residences as collateral. The proposal also stated that it would expire on November 8, 1978, at one o'clock in the afternoon. Fairco subsequently made a counterproposal on November 6, but the bank rejected it.[72]

Unable to reach a new understanding, the bank decided to proceed against the collateral offered as security for the original agreement. On November 6, a bank officer went to Clowntown, the store owned by Fairco, and closed the store, changed the locks, and secured the accounts. The bank then setoff Fairco's checking account against the debt owed to the bank. The next day Fairco repossessed the store, and the bank presented the partnership with a written demand for payment.[73] On November 8, Fairco accepted the bank's original proposal. After refinancing the loan at another institution, Fairco brought suit against Statebank. Fairco's complaint alleged that the bank had acted unrea-

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68. 674 P.2d 288 (Alaska 1983).

69. *See* Special Project Note, *Lender Liability, supra*, notes 29-57 and accompanying text.

70. *Fairco*, 674 P.2d at 289.

71. *Id.*

72. *Id.* at 290.

73. *Id.*

sonably in repossessing the collateral, resulting in damage to the business and personal reputations of Fairco's partners. The complaint also alleged that the bank had breached its duty of good faith.[74]

Because of the parties' course of dealings, their continued negotiations, and the absence of a demand for payment, an Alaska superior court concluded that the parties had modified their written agreement.[75] Thus, the court held that no default existed at the time of repossession by the bank.[76] Further, even if a default did exist on the fifty thousand dollar note, the bank had waived the default by failing to demand payment or give notice of default.[77] In particular, the superior court concluded that the partners of Fairco left the October 16 meeting with the "reasonable impression" that the bank would not require payment until after Christmas.[78]

The Alaska Supreme Court, in affirming this decision, emphasized that liability in lender-borrower cases often arises from the lender's practice of accepting late payments or creating an impression that an arrearage need not be paid immediately.[79] Thus, before the lender can sue on the note, it must notify the borrower that strict compliance with the agreement is going to be enforced in the future. After the lender notifies the borrower of its intention to enforce the agreement, it may call the loan due on the next default.[80]

It is difficult, however, to ascertain the course of conduct that modified the security agreement for the fifty thousand dollar note in *Fairco*. Looking at their course of dealings, it appears as though the bank made it clear to Fairco that the bank intended to enforce compliance with the written agreement. First, when Fairco defaulted on the first loan payment in June, the bank responded by executing a revised agreement with Fairco that postponed this payment until December.[81] This revision demonstrated the bank's desire for the written agreement to reflect the actual obligations of the parties and their intention to strictly enforce the written agreement. The court, however, ignored the bank's actions concerning the default. Second, when Fairco missed its September and October payments, an officer of the bank met with Fairco's part-

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74. *Id.* at 291. This duty of good faith is imposed by § 1-203 of Alaska's U.C.C. ALASKA STAT. § 45.01.203 (1986).

75. *Fairco*, 674 P.2d at 292.

76. *Id.*

77. *Id.*

78. *Id.*

79. The Alaska Supreme Court cited similar cases in other jurisdictions which had held the same way. *See, e.g.*, Pierce v. Leasing Int'l Inc., 142 Ga. App. 371, 235 S.E.2d 752 (1977); Nevada Nat'l Bank v. Huff, 94 Nev. 506, 582 P.2d 364 (1978).

80. *Fairco*, 674 P.2d at 292-93.

81. *Id.* at 289.

ners. This officer specifically refused Fairco's proposal to delay the note's repayment until after Christmas.[82] Yet, the court determined that this meeting had created the impression that Fairco would not be required to make payments until after Christmas. Third, the bank's proposal expressly stated that the note was in default. Certainly such a statement does not contribute to a course of dealing that would lead Fairco's partners to believe that "no default existed."[83] Nevertheless, the court held that the bank could not enforce the agreement as written.[84]

Bank Computer Network Corp. v. Continental Illinois National Bank[85] presents another example of a court's willingness to allow subsequent negotiations to alter the terms of a written agreement. In *Bank Computer* the plaintiff had signed two notes that had upcoming maturity dates of January 30, 1978, and February 13, 1978, respectively. Prior to these maturity dates, the plaintiff entered into negotiations with the defendant-bank for an extension of both notes and an additional loan. On February 6, 1978, the bank orally agreed to extend the notes and lend the plaintiff additional funds. On February 14, however, the bank sent two letters to the plaintiff. The first letter, a handwritten note, stated that the prior oral agreement was contingent on the plaintiff signing a personal guaranty for the entire amount of the notes. The second letter expressed the bank's desire to be paid in full on the maturity dates of the notes and outlined the procedures for the proposed oral agreement. In addition, this letter specifically denied that it was a proposal to advance funds. On February 21, the parties further negotiated the loan agreement setting forth three new options, none of which contemplated immediate demand for payment. The next day, however, the bank made written and oral demands for payment of the notes and offset the plaintiff's checking account against these debts.[86]

In considering the plaintiff's claim that the bank was promissorily estopped from collecting on the notes, an Illinois appellate court made several observations. The court agreed with the bank that its officers had never promised expressly in writing to forbear from collecting on the notes by offsetting plaintiff's checking account. Yet, the court held that the absence of such an expressed promise did not bar a claim of promissory estoppel. In order for the bank to be estopped by its promise, the promise only needs to be unambiguous, not expressed.[87] The

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82. *Id.* at 290.
83. *Id.* at 292.
84. *Id.* at 293.
85. 110 Ill. App. 3d 492, 442 N.E.2d 586 (1982).
86. *Id.* at 495-96, 442 N.E.2d at 589.
87. *Id.* at 497, 442 N.E.2d at 591.

court found an unambiguous promise in the letters exchanged between the parties.[88] Although almost every letter acknowledged the maturity dates of the notes, these acknowledgements were followed closely by invitations to renegotiate. In fact, one of the three options presented the day before the payment demand was a specific method of repayment. The court held that the bank was estopped from collecting on the notes by offsetting the plaintiff's checking account until the plaintiff had been given a reasonable time to accept and act on this option.[89] In addition, the court stated that the plaintiff reasonably could have believed that part of the oral agreement not contradicted by the subsequent written proposal was still in effect, thereby assuring the plaintiff that the bank would not collect until negotiations had ended.[90]

In contrast to *Fairco* and *Bank Computer*, which invalidated the written agreements in order to find for the borrower, other courts have not discarded the terms of the written agreements so quickly. In *Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association*[91] a savings and loan association agreed to lend Penthouse ninety-seven million dollars on June 20, 1983, with this commitment expiring 120 days from its issuance. On November 21, 1983, over 120 days from the issuance of the agreement, the parties agreed in writing to extend the expiration date to December 1, 1983, and the closing of the loan to a period no earlier than February 1, 1984, or no later than March 1, 1984. The project subsequently encountered problems and the loan agreement began to unravel. Negotiations were conducted prior to and after the March 1 deadline. In determining the impact of these negotiations on the loan agreement, the Second Circuit Court of Appeals stated that by continuing to negotiate after March 1, the parties may have extended the expiration date implicitly; however, because the parties previously had allowed the loan commitment to expire by its own terms, the court held that its construction of the unambiguous terms of the subsequent documents was not at odds with the parties' expectations.[92] The court concluded that its construction of the terms of these documents would not allow continuing negotiations to bar the expiration of the loan agreement.[93] Because the parties had dealt in the past

88. *Id.* at 498, 442 N.E.2d at 591.

89. *Id.*

90. *Id.* at 499, 442 N.E.2d at 592; *see also* Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964) (stating that the credit corporation representative's assurances, and the reasonable expectations created thereby, lulled the debtor into a false sense of security and, therefore, were tortious actions, notwithstanding the fact that the plaintiff knew the defendant's representative had no authority to make such assurances).

91. 855 F.2d 963 (2d Cir. 1988).

92. *Id.* at 976.

93. *Id.*

with a similar situation by executing a written extension, the court implied that the same practice would have been used in the present situation had they intended to extend the expiration date.[94]

On a broader scale, these cases illustrate the influence of a reliance-based theory on contract principles.[95] If a party has reasonably relied on another's assurance, expressed or implied, courts appear more willing to find a modification, or to estop the other party from claiming that the agreement has expired. The borrower, in reliance on a lender, forecloses other financing opportunities. If a lender fails to modify the agreement or to call a loan due, the borrower may experience severe consequences. The lender, on the other hand, suffers only minor damage because the original agreement and security arrangement normally are still enforceable. Renegotiating loan agreements in the lender-borrower context, therefore, provides a fertile ground for the extension of a reliance-based theory of contract. The rise of a reliance-based theory of contract and the significant impact lenders can have on borrowers partially explain holdings such as *Fairco* and *Bank Computer.*

2. Precautionary Measures for Avoiding Lender Liability

a. Negotiation Techniques

Under the pro-borrower theories espoused in *Fairco* and *Bank Computer*, a lender risks modifying or suspending its contractual rights under a written loan agreement by negotiating alternate payment plans with the borrower. The lender can reduce this risk, however, by taking several precautionary measures. First, any document listing the parties'

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94. This analysis, if applied to *Fairco*, possibly could have changed its outcome. In *Fairco* when the borrower defaulted the first time, the parties executed a revised loan agreement. This action, like the action in *Penthouse*, could have been interpreted as demonstrating the bank's intention to adhere to the terms of the written agreement. Thus, when Fairco defaulted and entered into further negotiations, the court could have held that the original loan agreement was in place until a written agreement was executed. The previous actions of the parties in a similar situation supported such a finding. The *Fairco* court, however, failed to address the impact of this prior situation on the later default.

Other concerns, apart from the course of the parties' conduct, may have motivated the *Penthouse* court to disallow modification. *Penthouse* involved a participation agreement in which a "lead lender" (Queen City Savings and Loan Association) agreed to loan Penthouse the necessary funds. The lead lender would then make agreements with "participating lenders" which would provide a portion of the necessary funds. As the name implies, the lead lender primarily would be responsible for overseeing the details of the entire loan package. The *Penthouse* court was concerned that in this type of arrangement, an implied extension would bind the participating lenders without giving them notice of the changed terms in the loan agreement. In such complex lending arrangements, the co-lenders must be able to trust that the agreement will be enforced as written. *Id.* at 981.

95. For a discussion of the impact of reliance on contract principles, see generally G. GILMORE, THE DEATH OF CONTRACT (1974).

options should include a statement preserving the lender's rights under the contract. This, of course, may impact negatively upon negotiations and be perceived by the borrower as a veiled threat. Most borrowers would not agree readily to a list of options that included a lender's right to demand payment immediately upon maturity of the loan and an option to secure any collateral. Thus, a lender should, at the very least, place a disclaimer in all written proposals, stating that all contractual provisions remain in force and strict compliance will continue to be required. Second, because reasonable reliance by the borrower is an increasingly important factor in determining liability, lenders should avoid making verbal assurances that run counter to the terms of the written agreement. Yet, even this may prove inadequate to protect the lender's rights. Indeed, the *Fairco* and *Bank Computer* courts focused on the negotiations themselves as creating the impression that financing would be continued and stated that the borrowers were justified in relying on this impression.[96] Thus, from a practical standpoint, a lender can best avoid liability by assuming that once it renegotiates the loan with the borrower, the bank has suspended its contractual rights. The bank can then enforce its contractual rights by notifying the borrower formally of its intent to do so and by providing the borrower with a reasonable time to react.

b. Demand Notes

A lender also can protect itself by using a demand note to loan money. Generally, a demand note is considered due and payable on its execution, whether or not there is a prior demand.[97] Thus, the only obligation placed on a holder of a demand note under the Uniform Commercial Code (U.C.C.) is to seek enforcement of the instrument within the statute of limitations.[98] This kind of note expressly gives a lender virtually unfettered discretion in dealing with the borrower, thereby making it difficult for a borrower to assert any reliance-based arguments. Courts, however, have restricted demand notes in several ways.

One constraint some courts have imposed on demand notes is a good faith restriction on the lender's discretion when enforcing the

96. *But see* Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985) (holding that a borrower's reliance on a bank officer's representations was unjustified because the officer told the borrower on several occasions that any loan extension would have to gain approval from a bank committee); *cf.* Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986) (stating that lender's silence regarding an intent to call a loan due during negotiations for an extension of the note was not a violation of its good faith duty).

97. U.C.C. § 3-122(1)(b) (1987); *see also* Spencer Cos. v. Chase Manhattan Bank, 81 Bankr. 194 (Bankr. D. Mass. 1987); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 518 P.2d 734, *cert. denied*, 419 U.S. 967 (1974).

98. Murphy v. First Nat'l Bank, 182 Ga. App. 788, 357 S.E.2d 266 (1987).

note.[99] *K.M.C. Co. v. Irving Trust Co.*[100] involved this type of constraint. In *K.M.C. Co.* Irving Trust agreed to provide K.M.C. with a line of credit in exchange for K.M.C.'s execution of a loan agreement that included a demand clause. K.M.C. also was required to place all receipts in a blocked account to which Irving Trust had sole access. Without notice, Irving Trust subsequently refused to loan K.M.C. any money even though the line of credit had not been exhausted. This left K.M.C. without operating capital, which caused its collapse. The *K.M.C. Co.* court stated that the demand provision of the loan agreement was like an acceleration clause and, therefore, should have been implemented only when reasonable and fair.[101] Thus, the court held that good faith required Irving Trust to have notified K.M.C. of its credit termination with sufficient lead time to have allowed K.M.C. to seek alternate financing.[102] This requirement, however, ran counter to the expressed terms of the agreement, which called for payment on demand, and is difficult to reconcile with the U.C.C., which puts no such restriction on demand notes.[103] Consequently, several courts have criticized the *K.M.C. Co.* holding and have declined to follow its reasoning.[104]

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99. *See generally* Special Project Note, *"Bad Faith Breach," supra.*

100. 757 F.2d 752 (6th Cir. 1985); *see also* Reid v. Key Bank of S. Me., 821 F.2d 9 (1st Cir. 1987).

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

102. *Id.* at 759.

103. *See* U.C.C. § 1-208 official comment (1987). Although U.C.C. § 1-208 provides that an "at will" or "when . . . insecure" acceleration term can only be enforced in good faith, the Official Comment to this section states that such a restriction does not apply to demand instruments "whose very nature permits call at any time with or without reason." *Id.*

104. *See, e.g., Spencer*, 81 Bankr. at 199 (refusing to accept *K.M.C. Co.* as the correct interpretation of New York law, stating that the *K.M.C. Co.* court "apparently overlooked the Comment to [§ 1-208]"); Flagship Nat'l Bank v. Gray Distrib. Sys., Inc., 485 So. 2d 1336, 1341 (Fla. Dist. Ct. App. 1986) (stating: "We refrain from following *K.M.C.* because we find that the court's citation of section . . . [1-208], which is inapplicable to demand notes, renders its holding somewhat suspect"); *Centerre*, 705 S.W.2d at 48 (stating that "this court does not find [*K.M.C. Co.*] . . . persuasive"); *see also* Taggart & Taggart Seed, Inc. v. First Tenn. Bank Nat'l Ass'n, 684 F. Supp. 230 (E.D. Ark. 1988) (citing *K.M.C. Co.* but not following it); Fulton Nat'l Bank v. Willis Denney Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980) (observing that a demand note is on its face immediately due, and an obligor should not be able to raise a good faith claim). The court in Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. Ct. App. 1986), distinguished *K.M.C. Co.* because the bank did not require Shaughnessy to deposit his proceeds into a blocked account.

In distinguishing several cases that did not find the lender liable, the *K.M.C. Co.* court stated: "Nor is it clear that the exercise of absolute discretion under the agreements in question [in these other cases] conferred on the banks the same power over the continued existence of the debtors as in the instant case." *K.M.C. Co.*, 757 F.2d at 759. Thus, *K.M.C. Co.* need not stand for the broad proposition that all demand notes have an implied obligation of good faith. Rather, when a bank places itself in a position to have almost complete control over a borrower's cash flow, then a duty to act in good faith will be imposed despite the use of a demand note. Yet, even this interpretation

Courts also restrict the scope of demand notes by defining them narrowly. For example, because demand notes become due and payable upon execution, courts do not allow loans with language contradicting these conditions to attain demand note status.[105] In scrutinizing the consistency of the language, a court will examine not only the demand note itself, but also all supporting documentation.[106] For example, in *Spencer Cos. v. Chase Manhattan Bank, N.A.*[107] a Massachusetts bankruptcy court concluded that a demand note, listing various contingencies that would render the note payable, was not intended to be due and payable on its execution.[108] If one of these contingencies did not occur, the lender was required to make a demand for payment prior to enforcing its contractual remedies.[109] Similarly, in *Shaughnessy v. Mark Twain State Bank*[110] a Missouri Court of Appeals found several terms in the loan documentation inconsistent with a demand note. These terms included the language "until maturity, March 6, 1984" and "become due at option of holder."[111] Because this language did not

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will be difficult to apply. "Control" will be determined by the amount of financial damage a lender will cause by exercising its contractual rights. If a borrower is financially weak, then the exercise of these rights will result in more serious economic damage. It is precisely when the borrower is financially weak, however, that these rights become valuable.

Thus, under this type of rule, a lender must engage in a causation analysis regarding the economic effects of its contemplated actions. Only if the lender's actions do not cause serious economic damage will the lender be deemed not to control substantially the borrower and be able to avoid the imposition of a good faith obligation. Such a process provides little certainty to a lender regarding his contractual rights.

Another court, *In re* Red Cedar Constr. Co., 63 Bankr. 228 (Bankr. W.D. Mich. 1986), attempted to limit *K.M.C. Co.*'s good faith duty to give notice only to loans involving future advances or disbursements (*e.g.*, a line of credit) and only when the lender had no reason to believe that the borrower would not be able to repay. The *Red Cedar* court stated that notice would have no effect upon a borrower who could not secure alternate financing. *Id.* at 238. The *Shaughnessy* court noted the anomalous result that limiting *K.M.C. Co.* to future advances would achieve: borrowers would be protected from a bank's refusal to disburse funds, but would be given no protection against the more onerous burden of having a demand note called due. *Shaughnessy*, 715 S.W.2d at 953. Applying the *Red Cedar* limitation would fail to protect those borrowers who most need safeguards such as good faith and instead protect those who may not need such protection. Thus, many courts seem to recognize the instability that would result if *K.M.C. Co.* were given a broad interpretation. Yet, short of outright rejection, it is difficult to arrive at a satisfactory limitation of this holding.

105. *E.g.*, *Spencer*, 81 Bankr. at 198. Simply calling an instrument a demand note does not make it so. Courts look beyond such labels and attempt to determine the intent of the parties from the language of the agreement and surrounding circumstances. *Id.*

106. *But see Allied Sheet Metal*, 10 Wash. App. at 530, 518 P.2d at 734 (stating that the provisions of a security agreement were irrelevant and inapplicable because the lender's actions were based on uncontroverted terms of the demand note).

107. 81 Bankr. 194 (Bankr. D. Mass. 1987).

108. *Id.* at 198.

109. *Id.*

110. 715 S.W.2d 944 (Mo. Ct. App. 1986).

111. *Id.* at 951; *see also* Reid v. Key Bank of S. Me., 821 F.2d 9 (1st Cir. 1987) (stating that a

show an intention for the notes to mature upon execution, the court concluded that a demand only could be made prior to maturity if a default occurred.[112]

Lastly, the prima facie tort doctrine limits a lender's discretion under a demand note. This tort provides a cause of action to a party which is injured intentionally by a lawful but unjustified act.[113] The intent to injure must be an actual intent to injure, not merely an intent to act.[114] A lender, however, has a defense to this tort so long as he acts with a valid business purpose.[115] Thus, the ability to establish a prima facie tort protects a borrower from malicious acts of the lender, but does not hinder a lender which is earnestly seeking to protect a valid business interest.

III. Requirement of a Writing

The Statute of Frauds, in a limited number of circumstances, requires that an agreement be written in order for it to be enforceable.[116] Credit agreements traditionally have not been subject to the Statute of Frauds.[117] Recently, however, several state legislatures have amended

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note was not a demand note because it listed certain occurrences which would render the note in default); Reese v. First Mo. Bank & Trust Co., 664 S.W.2d 530 (Mo. Ct. App. 1983) (holding that a promissory note was an installment note because many of the provisions in the loan documentation were inconsistent with the definition of a demand note).

112. *Shaughnessy*, 715 S.W.2d at 951.

113. *See* Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986). Four elements comprise the prima facie tort doctrine: 1) intentional lawful act by the defendant; 2) intent to cause injury to the plaintiff; 3) injury to the plaintiff; and 4) absence of any justification or an insufficient justification for the acts. *See id.* at 543; *see also* Special Project Note, *Lender Liability, supra*, notes 187-98 and accompanying text.

114. *Rigby*, 713 S.W.2d at 544.

115. *See Centerre*, 705 S.W.2d at 42. *Centerre* adopted a balancing test to determine whether a particular act was justified. This test stemmed from the *Restatement (Second) of Torts* § 870, comments f, g, h and i. The comments to this section list four factors to be balanced: 1) the "nature and seriousness of the harm"; 2) the "interests promoted by the actor's conduct"; 3) the type of means used; and 4) the actor's motive. Restatement (Second) of Torts § 870 comments f, g, h & i (1979).

116. *See* E. Farnsworth, *supra* note 1, § 6.1, at 370. The Statute of Frauds requires writings for contracts that:

> (1) "[C]harge any executor or administrator upon any special promise, to answer damages out of bis own estate . . . ;" (2) . . . "charge the defendant upon any special promise to answer for the debt, default or miscarriages of another person" (the suretyship provision); (3) . . . "charge any person upon any agreement made upon consideration of marriage" . . . ; (4) [charge] for the "sale of lands . . . or any interest in or concerning them" (the land contract provision); (5) [charge any person that is] "not to be performed within the space of one year from the making thereof" (the one-year provision).

Id.

117. The one-year provision might possibly apply to the lender-borrower context because most borrowers take longer than a year to repay loans. Courts, however, dislike this provision and have interpreted it to mean "not performable" within one year. *Id.* § 6.4, at 392. All loans can be

their Statute of Frauds to include agreements between lenders and borrowers.[118] Including lender-borrower agreements within the Statute of Frauds, however, has little real impact on actual lending practices because most lenders already use written documentation in their loan agreements. Indeed, an amendment to the Statute of Frauds in this area may be viewed as an attack on the body of law that has developed around the lender-borrower relationship, rather than as an attack on lending practices themselves. This section examines the potential impact of the Statute of Frauds on lender-borrower cases.

In general, the Statute of Frauds will affect a contract in at least two ways. First, in order to be enforceable, the original contract must be in writing[119] and signed by the party to be charged. Second, any modification that falls within the statute must meet the statute's requirements.[120] The Statute of Frauds should not be confused with the parol evidence rule. Although the Statute of Frauds requires a writing, unlike the parol evidence rule, it does not require that this writing be integrated. Thus, a writing can meet the requirements of the Statute of Frauds, but not trigger the application of the parol evidence rule.

Certain situations may cause a contract to be excepted from the Statute of Frauds. For example, the Statute of Frauds does not apply if there has been part performance, or if one of the parties is promissorily estopped.[121] Underlying these exceptions is a reliance-based theory of contract and the judiciary's unwillingness to allow a party to shield wrongful conduct by asserting the Statute of Frauds as a defense. These exceptions will allow courts, in jurisdictions that have included the lender-borrower relationship in their Statute of Frauds, to waive the

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repaid within one year and hence fulfill the terms of the obligation. Given this construction, few loans, if any, will fall within the traditional Statute of Frauds. *See* Third Nat'l Bank & Trust v. Sinder, No. CA9995 (Ohio Ct. App. June 18, 1987) (LEXIS, States library, Ohio file) (stating that an alleged oral contract for a bank to give advice to a borrower was not within Statute of Frauds because it could have been performed within one year).

118. *See* GA. CODE ANN. § 13-5-30(7) (Supp. 1988); MINN. STAT. ANN. § 513.33 (West Supp. 1989). South Dakota also addressed this area, but specifically exempted revolving loan account arrangements and credit card agreements from its coverage. S.D. CODIFIED LAWS ANN. § 53-8-2 (Supp. 1988). The *Wall Street Journal* recently reported that California passed a law that will prevent customers from suing banks for discontinuing credit, or refusing to extend new loans without a written agreement to perform such an obligation. *California Banks May Find Haven in a Law Curbing Suits on Lending*, Wall St. J., Oct. 18, 1988, at B8, col. 1. The article notes that exceptions to this rule will be made in several situations, including that of alleged fraud. *Id.* The act becomes effective Jan. 1, 1989. *Id.*

119. *See* J. CALAMARI & J. PERILLO, *supra* note 15, § 19-29. The writing must set forth with reasonable certainty: 1) the identity of the contracting parties; 2) the subject matter of the contract; and 3) the essential terms of the contract. *Id.*

120. *Id.* § 19-37.

121. *See id.* §§ 19-15, 19-48.

requirements of the Statute of Frauds.[122] Of course, a carefully drafted statute may restrict a court's ability to apply these exceptions.

A. *Minnesota Approach*

Minnesota is one of the states that has amended its Statute of Frauds to include credit agreements.[123] Subdivision 2 of the Minnesota statute places credit agreements within the Statute of Frauds. If the legislature simply wanted to place all credit agreements within the Statute of Frauds, this subdivision would fulfill that purpose. Of course, this subdivision alone would have little impact on cases involving part performance and promissory estoppel. From this perspective, subdivision 3 is the most significant provision of the amendment, equipping lenders with a powerful weapon to thwart recent lender liability holdings.

Subdivision 3, by focusing on what constitutes "new" credit agreements, deals with actions subsequent to written agreements. The specificity of this subdivision forecloses a court from applying reliance-based legal theories to certain actions of the lender. Two cases have been decided under this statute since its enactment in May 1985.

In *Becker v. First American State Bank*[124] the plaintiff alleged that the bank, through its president, orally agreed to continue financing the plaintiff's business if he would reduce his indebtedness. In reliance on this oral agreement, the plaintiff immediately sold several parcels of land at significantly less than market value. The bank subsequently honored the plaintiff's overdrafts in excess of one hundred fifty thousand dollars and had the plaintiff sign an unsecured note for one hundred and forty-five thousand dollars to cover these overdrafts. The plaintiff requested an additional loan, but the bank refused. The plain-

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122. Both the *Fairco* and *Bank Computer* holdings were based on principles of estoppel. An amendment to the Statute of Frauds would have little impact on such cases.

123. MINN. STAT. ANN. § 513.33 (West Supp. 1989). The amendment states:

Subd.2. Credit agreements to be in writing. A debtor may not maintain an action on a credit agreement unless the agreement is in writing, expresses consideration, sets forth the relevant terms and conditions, and is signed by the creditor and the debtor.

Subd. 3. Actions not considered agreements. (a) The following actions do not give rise to a claim that a new credit agreement is created, unless the agreement satisfies the requirements of subdivision 2:

(1) the rendering of financial advice by a creditor to a debtor;

(2) the consultation by a creditor with a debtor; or

(3) the agreement by a creditor to take certain actions, such as entering into a new credit agreement, forbearing from exercising remedies under prior credit agreements, or extending installments due under prior credit agreements.

(b) A credit agreement may not be implied from the relationship, fiduciary, or otherwise, of the creditor and the debtor.

Id.

124. 420 N.W.2d 239 (Minn. Ct. App. 1988).

tiff then sued the defendant-bank for damages arising from his "quick sale" of property.[125]

A Minnesota trial court granted the bank's motion for summary judgment, and the appellate court affirmed.[126] The appellate court held that the bank's recommendation for the plaintiff to reduce his indebtedness constituted a "rendering of advice" pursuant to the amended Minnesota statute.[127]

In *Fronning v. Blume*[128] the plaintiff purchased a farm from his parents in September 1977, financing the purchase with a contract for deed. The plaintiff used the defendant-bank to finance both his farm operations and his personal needs. Between September 1977 and April 1984, the plaintiff's debt grew from 67,500 dollars to over 132,000 dollars. The loans were secured by the plaintiff's farm machinery and livestock.[129]

The plaintiff regularly consulted John Blume, a loan officer of the bank, on all financial matters. Blume's record of the plaintiff's account evidenced a steady effort by the bank to secure the plaintiff's debt further. In April 1985 the plaintiff signed a note that renewed his 132,000 dollar loan due in November 1985. At that time the plaintiff also executed two additional agreements and promissory notes for lines of credit totalling 31,500 dollars. The bank disbursed 24,500 dollars of this amount to the plaintiff, and the remaining 7,000 dollars was designated for the purchase of a tractor. The plaintiff, however, obtained alternate financing for this purchase. These credit agreements did not obligate the defendant-bank to lend the plaintiff any money, but rather allowed the bank to make these loans in its sole discretion.[130]

On April 17, at the bank's request, the plaintiff and his family went to Blume's office to sign a document. The plaintiff's father objected to signing the document, but Blume assured them that the document served only an in-house function and did not "mean a thing."[131] Although the plaintiff looked at the document, he neglected to see the printed word "mortgage." In September 1985 the bank refused to extend further credit to the plaintiff. The plaintiff subsequently discovered that the bank had a mortgage on his property. Blume discussed with the plaintiff's attorney the possibility of an auction sale in February 1986. The plaintiff then sold his equipment and hogs and applied

125. *Id.* at 240.
126. *Id.* at 239.
127. *Id.* at 241 (citing MINN. STAT. ANN. § 513.33(3)(a)(1) (West Supp. 1989)).
128. 429 N.W.2d 310 (Minn. Ct. App. 1988).
129. *Id.* at 311.
130. *Id.*
131. *Id.* at 312.

the 53,164 dollars received toward his debt with the bank.[132]

The plaintiff sued the bank, alleging that the bank fraudulently obtained the mortgage and acted in bad faith by cutting off the plaintiff's credit without notice and by refusing to release promised funds. A Minnesota trial court granted the bank's motions for summary judgment on both of the plaintiff's claims.[133] The trial court found that Blume's statements regarding the nature and effect of the mortgage were not fraudulent inducement because the document clearly stated that it was a mortgage and set forth its significant legal effects. Blume's statements were contrary to the document's terms, thereby making the plaintiff's reliance upon them unreasonable. Because there was no reasonable reliance on the part of the plaintiff, the court refused to allow parol evidence to vary the terms of the written agreement.[134]

The Minnesota Court of Appeals, however, reversed the trial court's determination concerning the issue of fraud.[135] The court held that Blume's statements could be admitted to prove that the parties never intended to enter into a mortgage arrangement, notwithstanding the language of the document.[136] The court of appeals stated that the parol evidence rule did not exclude evidence of fraudulent oral representations that induced a party to enter into a written agreement.[137] Summary judgment on the issue of fraud, the court held, was inappropriate because the trier of fact could find that the parties never intended to enter into a mortgage agreement.[138]

The appellate court, however, affirmed the trial court's summary judgment on the issue of bad faith.[139] The court examined and rejected three arguments made by the plaintiff under this claim. The plaintiff first contended that the bank acted in bad faith by not fulfilling its oral promises to give the plaintiff a larger part of the proceeds received by the bank from the sale of the plaintiff's grain.[140] Pursuant to the parties' security agreement, these grain checks were intended to pay off the plaintiff's prior loan. Thus, any money given to the plaintiff from these proceeds, the court reasoned, would result in a new loan. The defendant-bank's alleged oral promises, therefore, constituted a credit agree-

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132. *Id.*
133. *Id.*
134. *Id.* at 313.
135. *Id.* at 314.
136. *Id.* at 313.
137. *Id.*
138. *Id.*
139. *Id.* at 314.
140. *Id.* Apparently the plaintiff and the bank had some sort of security agreement whereby the plaintiff's customers made payments to the bank. *Id.* Using accounts receivable to secure a short-term loan is a common practice in the banking industry.

ment under the Minnesota statute and required a writing.[141]

Second, the plaintiff further alleged that the bank acted in bad faith by refusing to extend further credit beginning in September 1985.[142] The plaintiff maintained that his course of dealing with the bank required the bank to extend credit, or to give notice that no new credit would be permitted. The court concluded that the Minnesota statute prevented the creation of a credit agreement solely through implications from the relationship of the parties or their past dealings.[143]

Lastly, the plaintiff argued that he was entitled to the undisbursed 7,000 dollars that had been made available to him under the discretionary lines of credit. Although conceding that these agreements satisfied the Minnesota statute, the court held that the contracts expressly disclaimed any obligation to dispense these funds.[144] The plaintiff countered this ruling by arguing that the past dealings of the parties created this obligation. The court disagreed, concluding that the Minnesota Commercial Code allows the parties' course of dealings to interpret the written agreement, but not to contradict it.[145] The plaintiff offered no evidence of a prior agreement between these parties that would have caused the plaintiff to believe that he was to receive the full amount of the loan regardless of the loan's purpose. Moreover, the purpose of the loan had disappeared because the plaintiff had obtained alternate financing.

Both of these cases illustrate the pivotal role of subdivision 3 within the framework of this amendment. Lacking the specific language of this subdivision, the *Becker* and *Fronning* courts, guided by recent decisions in other jurisdictions, could have decided for the borrower despite the requirement of the Statute of Frauds. Such statutory specificity, therefore, will protect lenders when dealing with borrowers after making a loan.

B. Georgia Approach

Georgia's amendment to its Statute of Frauds requires a writing for "[a]ny commitment to lend money."[146] Since the enactment of the stat-

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141. *Id.*
142. *Id.*
143. *Id.*
144. *Id.*
145. *Id.*; *see also* MINN. STAT. ANN. § 336.1-205(1) (West 1966) (defining a course of dealing as "a sequence of previous conduct between the parties to a particular transaction which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct").
146. GA. CODE ANN. § 13-5-30(7) (Supp. 1988). The amendment reads in part:

> To make the following obligations binding on the promisor, the promise must be in writing and signed by the party to be charged therewith or some person lawfully authorized by him:

ute on July 1, 1988, no cases have been decided under it. Nevertheless, certain observations can be made.

This amendment places few restrictions on courts. Although all commitments to lend money must be in writing, lenders will find little protection from such language. The doctrines of part performance and promissory estoppel, coupled with recent holdings in other jurisdictions, provide Georgia courts with the necessary ingredients to except a contract from the statute's requirements. Thus, this sparsely worded statute may have little impact on lender liability cases.

Courts, however, could look beyond the wording of the statute in order to enforce the "purpose" behind the statute. If courts consider this amendment as a legislative desire to bridle recent lender liability cases, they could interpret "commitment" expansively and include the same actions cited by the Minnesota statute in subdivision 3. If nothing else, the Georgia statute gives courts the latitude to strike a balance between banking stability and borrower recourse based on the equities of the situation.[147] This flexibility works in the borrower's favor and in this regard is superior to the Minnesota statute, which enhances banking stability by foreclosing borrower recourse in certain situations regardless of the equities. The direction courts will take with Georgia's amendment, however, remains unknown. Thus, banks are provided with little guidance to conduct current lending transactions.

IV. Conclusion

Three concerns underlie attempts to resolve lender-borrower disputes: maintenance of banking stability through the enforcement of written contracts, avoidance of adhesion contracts, and provision of legal recourse to borrowers against abusive lending practices. Unfortunately, because these concerns are at odds with each other, no guidelines have been established that satisfactorily address each concern. Thus, the best guidelines will be clear rules that properly balance these concerns.

In contract law, courts have sought to provide this clarity and balance by enforcing disclaimer clauses in written contracts. Disclaimer clauses protect lenders' written agreements from the demise of the pa-

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(2) A promise to answer for the deht, default, or miscarriage of another;

. . . .

(5) Any agreement that is not to he performed within one year from the making thereof;

(6) Any promise to revive a debt barred hy a statute of limitations; and

(7) Any commitment to lend money.

Id.

147. *See id.*

rol evidence rule. Borrowers cannot sign an agreement containing a disclaimer clause and then allege that they relied on a promise not contained in the written agreement. These disclaimer clauses, however, encourage the use of boilerplate language and may be a trap for borrowers who are unaware of the legal effect of these clauses. Moreoever, a borrower, lacking sufficient bargaining power, may have no alternative other than to sign an agreement containing such a clause. The enforcement of disclaimer clauses, therefore, maintains banking stability but fails to address any concerns of the borrowers.

Promissory estoppel and other reliance-based legal theories increasingly influence the judiciary's contractual analysis and strengthen borrowers' claims. This influence is particularly evident in cases involving negotiations subsequent to the written agreement. Although these theories provide borrowers with recourse against lenders and help to circumvent adhesion contracts, it is difficult to predict the actions that will give rise to a claim under these theories. Thus, the integrity of lending agreements is weakened, and banks are uncertain about the actions that they should take to keep their loans secure while still avoiding liability.

Several state legislatures have amended their Statutes of Frauds in an effort to address lender-borrower concerns. This solution balances lender-borrower concerns in several ways. First, banking stability would be maintained because of the deference given to written agreements. Certain lender-borrower agreements would have to be in writing to be enforceable. An amendment to the Statute of Frauds would affect both initial agreements and any subsequent modifications. From a lender's perspective, this solution is superior to a disclaimer clause because of its greater scope. A disclaimer clause only impacts on actions prior to the written agreement, whereas an amendment to the Statute of Frauds affects all actions, prior and subsequent to the written agreement.

Second, this solution addresses the borrowers' concerns. Although an agreement normally must be in writing to be enforceable, the doctrines of partial performance and promissory estoppel are available to borrowers and help to police the actions of the lender. Thus, unlike the disclaimer clause solution, a borrower may assert reliance-based causes of action despite the requirement of a writing.

Lastly, a carefully drafted amendment to the Statute of Frauds provides clear guidelines to lenders and borrowers concerning the effect of particular actions on written agreements. Having advance knowledge that certain actions will not be construed as an agreement unless made in writing, lenders will be more willing to perform these acts. Hence, assuming that the affected actions will include negotiations and rendering advice, greater cooperation between lender and borrower may result. This certainty also may reduce transaction costs because lenders could better calculate the risks inherent in making loans. An amendment to the Statute of Frauds, therefore, would balance lender-borrower concerns and bring greater certainty to the lending process.

Robert D. Rowe