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The Doctrine of Lender Liability

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NOTES

THE DOCTRINE OF LENDER LIABILITY

I. INTRODUCTION

Not long ago, banks worried merely about the default of borrowers in financial distress. Today, a grave new concern faces banks — the possibility borrowers will file suit against the bank and win under the new doctrine of lender liability. Under this doctrine, liability may

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*This note is dedicated to my parents, Mr. & Mrs. Marshall R. Cassedy, in appreciation for making law school possible for me.

exceed the loan amount and is compounded by legal fees and use of valuable time necessary to defend the lawsuit.[1] Multimillion dollar jury verdicts awarded against lenders have shaken the foundations of the banking industry.[2] Bankers have now joined the ranks of those targeted for malpractice suits.[3]

Borrowers most often initiate lender liability suits following commercial loan defaults. Theories for liability include interference with corporate governance,[4] fraud,[5] duress,[6] misrepresentation,[7] negli-

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1. Lenders often face judgments exceeding the loan amount when punitive damages are awarded. *See, e.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (a $7.5 million judgment was awarded against the lender with $6 million awarded as punitive damages). *Id.* at 759; State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984) (the borrower received a $18,647,243.77 judgment against lender); LeMaire v. MBank Abilene, No. 52,567 (Dist. Ct. of Fort Bend County, 240th Judicial Dist. of Texas, Aug. 12, 1986) (borrower received a judgment of nearly $70 million for lender's failure to fund a $3 million loan commitment) (*cited in* Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411, 412 n.2 (1987)).

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

3. A recent Florida case has added maladministration to the string of theories levered against lenders. *See Does Lender Liability Now Include Banker Malpractice?*, U.S. BANKER, May 1986, at 26. In this case between Atrio Consolidated Industries and Southeast Bank of Miami, the judge asked the jury whether the bank owed the borrower any duty of care beyond the written loan agreements. *Id.* The jury responded positively by awarding the borrower $12 million ($9 million of which was punitive damages). *Id.* Before an appeal was pursued, the case settled for a significant amount. *Id.*

4. *See infra* text accompanying notes 80-123.

5. *See infra* text accompanying notes 99-104.

6. *See infra* text accompanying notes 100-04.

7. Lenders that improperly induce other creditors to extend credit to a common debtor have been held liable. *See, e.g.*, Central States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405 (6th Cir. 1984) (lender held liable for misrepresenting debtor's financial condition to one of debtor's customers). The lender used the customer's subsequent payment to the debtor to reduce the lender's loan rather than to construct the customer's machine. *Id.* at 1407. The court held that once the lender answered, it had a duty to answer honestly. *Id.* at 1409. *See also* General Motors Acceptance Corp. v. Central Nat'l Bank, 773 F.2d 771 (7th Cir. 1985) (lender's misleading careless response is actionable); Berkline Corp. v. Bank of Miss., 453 So. 2d 699 (Miss. 1984) (creditor allowed to recover on theories of fraud and negligent misrepresentation for a bank's material misrepresentations concerning a customer's creditworthiness); Herbert, *Truth or Consequences? A Bank's Liability for Erroneous Assurances Concerning a Customer's Account*, 6 ANN. REV. OF BANKING L. 95 (1987).

Misrepresentations to third parties made to induce investments may be actionable under securities laws. *See* First Va. Bankshares v. Benson, 559 F.2d 1307 (5th Cir. 1977) (jury could find that bank had a duty to disclose subsequent discoveries of gross inaccuracies in company books), *cert. denied*, 435 U.S. 952 (1978); United States Steel & Carnegie Pension Fund v. Orenstein, 557 F.2d 343 (2d Cir. 1977). Further, a lender's course of conduct which induces a third party to supply goods on credit can lead to lender liability for the cost of the goods. *See* Gulf Oil Trading Co. v. Creole Supply, 596 F.2d 515 (2d Cir. 1979).

gence,[8] and breach of good faith.[9] Borrowers also assert claims based

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However, courts have imposed a general duty of confidentiality on banks precluding them from divulging information concerning customer accounts. United States v. First Nat'l Bank, 67 F. Supp. 616, 624 (S.D. Ala. 1946); Peterson v. Idaho First Nat'l Bank, 83 Idaho 578, 588, 367 P.2d 284, 290 (1961); Denson State Bank v. Maderirci, 230 Kan. 684, 640 P.2d 1235 (1982). Hence, a lender's disclosure about a borrower can lead to a borrower suit for breach of confidentiality. Graney Dev. Corp. v. Taksen, 92 Misc. 2d 764, 400 N.Y.S. 2d 717 (1978). While this general obligation of confidentiality was recognized in Florida in Milohnich v. First Nat'l Bank, 224 So. 2d 759 (Fla. 3d D.C.A. 1969), it was qualified by the Florida Supreme Court in Barnett Bank v. Hooper, 498 So. 2d 923 (Fla. 1986).

In *Barnett Bank*, Hooper began banking with Barnett Bank in 1973. *Id.* at 924. In 1981, Hooper met with Hosner, an attorney and a Barnett Bank customer, to discuss tax shelters. *Id.* Hosner took Hooper to meet with a bank officer, Riffel, who was in charge of Hosner's accounts. *Id.* Riffel told Hooper that Hosner Investments was financially sound and had passed the scrutiny of the Internal Revenue Service. *Id.* Hooper then borrowed $50,000 from the bank to invest with Hosner. *Id.* On May 13, 1982, the bank suspected Hosner of a check kiting scheme and returned all of Hosner's checks to protect the bank. *Id.* Riffel was aware of Hosner's suspected scheme. On May 14, Hosner and Hooper contacted Riffel. Hooper requested a $90,000 loan to invest further with Hosner Investments. *Id.* Riffel arranged the loan. By May 24, the check kiting scheme was confirmed, but because of Hooper's last investment the bank did not suffer a loss.

Hooper sought to cancel the promissory note on the basis that he and the bank had developed a confidential relationship requiring the bank to disclose facts material to the loan transaction. *Id.* While the Florida Supreme Court recognized the bank's general duty of confidentiality to its customers, the court found banks may have a duty to disclose under special circumstances. *Id.* at 925. The supreme court held that when a bank becomes involved in a transaction with a customer with whom the bank has established a relationship of trust, and the bank is likely to benefit from the transaction at the customer's expense, the bank may have a duty to disclose material facts about the transaction otherwise unavailable to the customer. *Id.* Hence, the jury could have found the bank had established a fiduciary relationship with Hooper and owed him a duty to disclose the check kiting scheme. *Id.* at 926. The jury was entitled to weigh the bank's duty of disclosure to Hooper against its duty of confidentiality to Hosner. *Id.* The court reversed the summary judgment in the bank's favor and remanded the case for a new trial. *Id.*

The *Barnett Bank* case seems to fall in line with an emerging trend to disclose facts when failure to do so would be harmful. *See* Beneficial Commercial Corp. v. Murray Glick Datsun, Inc., 601 F. Supp. 770 (S.D.N.Y. 1985).

8. Negligence can be used to allege lender misconduct at various stages of the lending transaction. For cases asserting liability for negligence in processing a loan, see First Fed. Sav. & Loan Ass'n v. Caudle, 425 So. 2d 1050 (Ala. 1980); Wagner v. Benson, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980); Jacques v. First Nat'l Bank, 62 Md. App. 54, 488 A.2d 210 (1985), *rev'd*, 515 A.2d 756 (Md. 1986). For cases asserting liability for negligence in loan administration, see Brunswick Bank & Trust Co. v. United States, 707 F.2d 1355 (D.C. Cir. 1983); Columbia Plaza Corp. v. Security Nat'l Bank, 676 F.2d 780 (D.C. Cir. 1982). For cases asserting liability for reckless disregard of borrower's rights over a long period, see Mitchell v. Ford Motor Credit Co., 688 P.2d 42 (Okla. 1984).

9. *See infra* text accompanying notes 135-93.

on federal statutes under securities laws,[10] environmental laws,[11] tax laws,[12] bankruptcy laws,[13] and RICO.[14]

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10. A lender may be found to control the debtor to the extent that the lender is secondarily liable for violating federal securities laws. Section 20(2) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t(a) (1982) is the basis for a lender's secondary liability for security violations. For further information, see Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343, 352-63 (1975); Flick & Replansky, *Liability of Banks to Their Borrowers: Pitfalls and Protections*, 103 BANKING L.J. 220, 228-32 (1986); Lundgren, *Liability of a Creditor in a Control Relationship with Its Debtor*, 27 CORP. PRAC. COMMENTATOR 1 (1985).

11. Environmental laws may assess clean-up costs against a lender if hazardous or toxic materials are discovered on mortgaged premises. This liability is based on the Federal Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. §§ 9601-57 (1986). *See* United States v. Maryland Bank & Trust, 632 F. Supp. 573 (D. Md. 1986); United States v. Mirable, No. 84-2280, slip op. (E.D. Pa. Sept. 4, 1985); *see also* Burcat, *Environmental Liability of Creditors: Open Season on Banks, Creditors and Other Deep Pockets*, 103 BANKING L.J. 509 (1986); Burcat, *Environmental Liability of Creditors under Superfund*, PRAC. LAW., Mar. 1987, at 13 (forms included); Schwenke, *Lender Liability for Hazardous Waste Cleanup Expenses*, 1 PROB. & PROP., Jan.-Feb. 1987, at 43.

12. Under 26 U.S.C. §§ 3505, 6672 (1986), a lender may be held responsible for unpaid taxes. *See* United States v. McMullen, 516 F.2d 917 (7th Cir.), *cert. denied*, 423 U.S. 915 (1975); Dallas v. United States, 68-1 U.S.T.C. ¶ (CCH) 9290 (Feb. 14, 1968).

13. Finding a creditor controlled a debtor can result in the creditor being classified as an "insider" of the debtor under the Bankruptcy Code. 11 U.S.C. § 101(30)(B)(iii), (V) (1986). If the creditor is classified as an insider, the preference period is extended from 90 days to one year during which payments to the creditor may be challenged. 11 U.S.C. § 547(b)(4)(B) (1986). *See* Note, *The Term Insider Within Section 547(b)(4)(B) of the Bankruptcy Code*, 57 NOTRE DAME LAW. 726 (1982). An insider's vote for or against a reorganization plan may not be counted in determining a class' acceptance or rejection of a plan. 11 U.S.C. § 1129(a)(10) (1986). Finally, this insider status resulting from excessive control may result in the subordination of the creditor's claim through the doctrine of equitable subordination. 11 U.S.C. § 510(c) (1986).

The Bankruptcy Code expressly recognizes equitable subordination. However, no guidelines are set forth for its application, leaving this matter to case law. *See* DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417 (1985). *See also* Chaitman, *The Equitable Subordination of Bank Claims*, 39 BUS. LAW. 1561 (1984). The mere ability to exercise control is not sufficient for subordination. The claimant must have exercised the control which results in actual injury to another. Comstock v. Group of Institutional Lenders, 335 U.S. 211 (1948); Wood v. Richmond, 536 F.2d 299 (9th Cir. 1976); *In re* Prima, 98 F.2d 952 (7th Cir. 1938); *In re* Osborne, 42 Bankr. 988 (Bankr. W.D. 1984); DeNatale & Abram, *supra* at 432-34.

14. Under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-65 (1986), a claimant may recover treble damages. This makes the statute extremely attractive to potential plaintiffs and should provide stimulus for lenders to assiduously avoid conduct exposing them to liability under RICO. For cases where the court has allowed a borrower to proceed with a RICO claim alleging interest overcharges, see Haroco v. American Nat'l Bank & Trust Co., 747 F.2d 384 (7th Cir. 1984); Morosani v. First Nat'l Bank, 703 F.2d 1220 (11th Cir. 1983); Wilcutts v. Jefferson Trust & Sav. Bank, Civ. No. 82-1153 (C.D. Ill. Apr. 21, 1982); Mooney v. Fidelity Union Bank, Civ. No. 82-3192 (D.N.J. Mar. 22, 1983); Coastal Steel Corp. v. Chemical Bank, Civ. No. 82-1714 (D.N.J. Oct. 27, 1982); Shaw v. Oregon Bank, Civ. No. 82-126 (B.E. Ore. May 17, 1982).

Borrowers facing financial difficulty often feel at the lender's mercy. Fearing the loan will be called and subsequent insolvency will ensue, borrowers feel they lack leverage to control an overreaching creditor.[15] Today, the balance of power is shifting. Borrowers are fighting back and winning.[16] Lenders, however, are in a dilemma.[17] They may face harsh consequences if they do not help a financially troubled debtor, and a strong potential for liability if they do.[18] Lenders can avoid this situation, however, if they understand the parameters of proper lender conduct.

One ramification of the new wave in lender liability is a restructuring of traditional banking practices. New standards for proper lender conduct are being set. This emerging body of law requires careful examination not only by lenders wishing to avoid such liability, but also by borrowers wishing to ensure their rights are properly protected.

Two areas dominate lender liability: liability for excessive control and for breach of good faith. This note will analyze the theories in these major areas and pinpoint theories most suitable to redress lender misconduct. This note will then examine the role played by creditors in the actual operation of the credit market, to explore limits which should be placed on lender liability. Finally, the note will highlight reasonable standards of conduct bankers should adopt to avoid liability.

II. Control Liability

Potential for liability frequently arises when the lender interferes with or exerts some control over the debtor, typically over the debtor's business operations.[19] A lender may assert control to prevent the debtor from going bankrupt or to salvage as much of the loan as possible in the event of the debtor's insolvency.[20] Even in the absence of financial erosion, a lender often will exert some control over the

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15. To remedy this situation, courts often impose a duty of good faith on the lender. *See infra* text accompanying notes 192-211. For example, in K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985), the court found the failure to imply a duty of good faith on the lender would make the contract unreasonable, and put the borrower at the lender's mercy. *Id.* at 759.

16. Moss, *Borrowers Fight Back With Lender Liability,* A.B.A. J., Mar. 1, 1987, at 64.

17. Swartz, *supra* note 2, at 15.

18. *Id.*

19. *See, e.g.,* State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984) (lender liable for excessive control over management of borrower's business).

20. *See, e.g.,* Melamed v. Lake County Nat'l Bank, 727 F.2d 1399, 1404 (6th Cir. 1984) (lender held liable for tortious interference with the debtor's operations to salvage whatever possible).

debtor to monitor collateral and to protect the lender's interests.[21] The rationale behind imposing liability for excessive control is that the controlling creditor benefits from the exertion of control at the expense of the debtor or junior creditors.[22]

Control may be manifested in various ways. A lender may obtain voting control,[23] participate on the debtor's board of directors,[24] gain control of management,[25] exert financial control,[26] or interfere with

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21. A lender which monitors collateral or the debtor's operations focuses on preventing debtor misconduct. For instance, a debtor may misbehave by changing investment policies or business projects which increase the variability of the firm's assets. The debtor may also convert business assets to private use or dilute the creditor's claim by issuing additional risky debt. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901, 919-22 (1986). Instead of monitoring the debtor, the lender often inserts convenants or restrictions forbidding debtor misconduct. These contractual substitutes, together with leverage provided by a security interest in the debtor's collateral, may give rise to liability for latent control. *Id.* at 935. However, courts differ as to whether control must be exercised to create liability. For instance, a split in authority exists as to whether, under § 20(a) of the Securities Exchange Act of 1934, mere power to control is sufficient to impose liability or whether actual control must be exercised. For cases holding that mere potential for control is sufficient, see Savino v. E.F. Hutton & Co., 507 F. Supp. 1225, 1243 (S.D.N.Y. 1981) (plaintiff must only allege a position of control to state a claim under § 20(a)); Sharp v. Coopers & Lybrand, 457 F. Supp. 879, 892 (E.D. Pa. 1978) (control depends upon whether the defendant had the power or potential power to exert influence), *aff'd*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982); Harriman v. E.I. DuPont De Nemours & Co., 372 F. Supp. 101 (D. Del. 1974). *See also* Gilbertville Trucking Co. v. United States, 371 U.S. 115 (1962) (under the Interstate Commerce Act, control does not have to be actually exercised). For more discussion on the contents of loan agreements, see Nassberg, *Loan Documentation: Basic but Crucial*, 36 BUS. LAW. 843 (1981); Simpson, *Structuring and Documenting Business Financing Transactions Under the Federal Bankruptcy Code of 1978*, 35 BUS. LAW. 1645 (1980); Simpson, *The Drafting of Loan Agreements: A Borrower's Viewpoint*, 28 BUS. LAW. 1161 (1973).

22. Schechter, *The Principal Principle: Controlling Creditors Should Be Held for Their Debtor's Obligations*, 19 U.C. DAVIS L. REV. 875, 882-84 (1986); Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411, 434 (1987).

23. Power to vote corporate stock means a lender may have substantial influence in electing the board of directors. This can be interpreted as control over the company. Commentators suggest lenders should shun voting power to avoid the slightest appearance of impropriety. D. ROME, BUSINESS WORKOUTS MANUAL ¶ 8.03, at 8-9, 8-10 (1985).

24. This occurs where a director serves simultaneously on the boards of both the lender and borrower. For a general discussion of interlocking directorships, see *id.* at 8-11 to 8-12.

25. Through contractual loan provisions, a lender may gain veto power or otherwise control day-to-day management of the debtor's operations. For an example where this led to liability, see State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984).

26. Financial control occurs when a lender obtains control over the debtor's finances sufficient to enable lender to determine economic viability of the business. The lender may regulate the debtor's cash flow or dictate financial judgments. *See* D. ROME, *supra* note 23, at 8-13 to -14.

the borrower's other contractual relationships.[27] Excessive control may result in subordination of the lender's claim to general creditor status because of equitable subordination,[28] liability to the debtor's creditors or other third parties,[29] or liability to the debtor for lost profits.[30]

A. *Development of Control Liability*

As a developing area of the law, the doctrine of lender liability lacks historical foundation. Although common law recognized the present theories used to impose liability, these theories only recently have been applied to the lending industry. The few early cases which sought to impose liability on a lender for exerting control over the borrower's operations were largely unsuccessful.[31] Borrowers were unsuccessful perhaps due to inadequate representation and the use of theories not well adapted for application to the lending industry.[32]

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27. Petrich v. Nurseryland Garden Centers, Inc., 140 Cal. App. 3d 243 (1983). However, if a lender is protecting a financial interest and the lender's conduct is not otherwise wrongful, the conduct may be privileged. Del State Bank v. Solomon, 548 P.2d 1024 (Okla. 1976); RESTATEMENT (SECOND) OF TORTS § 769 (1979) states:

> One who, having a financial interest in the business of a third person, intentionally causes that person not to enter into a prospective contractual relation with another, does not interfere improperly with the other's relation if he (a) does not employ wrongful means and (b) acts to protect his interest from being prejudiced by the relation.

28. *See supra* note 13.

29. *See* Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974); A. Gay Jenson Farms v. Cargill, Inc., 309 N.W.2d 285 (Minn. 1981); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. App. 1984). Liability to other third parties generally occurs where the lender's interference with the debtor's operations has resulted in termination or debtor's breach of contract with a third party. *See* Melamed v. Lake County Nat'l Bank, 727 F.2d 1399 (6th Cir. 1984).

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

31. Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41 (8th Cir. 1916); American S. Trust Co. v. McKee, 173 Ark. 147, 293 S.W. 50 (1927).

32. Presumably, financially troubled debtors typically could not afford adequate counsel. Lenders, on the other hand, occupied a better financial position and were probably more adequately represented. The asserted theories often were not easily adapted to the lender-borrower relationship and were difficult to prove. For example, the instrumentality theory borrowed from corporate law imposes a stringent standard of complete domination to impose liability. *See infra* notes 187-91 and accompanying text for an explanation of why this theory is not easily adapted to the lender-borrower relationship.

An early case demonstrating the difficulty of proving a lender's liability under the instrumentality theory is Chicago Mill & Lumber Co. v. Boatmen's Bank, 234 F. 41 (8th Cir. 1916). In *Chicago Mill*, a junior unsecured creditor proceeded against the senior bank creditor. The junior creditor sought payment for an obligation owed by the common debtor, a mill company. The bank, after becoming dissatisfied with the mill's operation, arranged to have its assistant cashier elected as the mill's president. *Id.* at 43-44. The bank also chose a new general manager. *Id.*

Today, the situation has changed. Sophisticated lawyers are aggressively representing borrowers' interests, offering ingenuity in the use of traditional theories.

To develop the lender liability doctrine, borrowers have innovatively adapted a myriad of traditional theories for the lending industry.[33] Some theories are better suited than others to curb lender misconduct.[34] These theories each impose liability depending on the degree of control over or interference with the borrower. The theories range from liability for the mere potential to exert control,[35] to theories such as instrumentality which require a lender's complete domination of the borrower.[36] Lender liability is a constantly evolving body of law.[37] No concrete rules have been set, so lenders can only learn from others' mistakes. This problem requires a close factual analysis of the major cases under each theory. The following discussion examines the control liability theories and the amount of control a plaintiff must prove under each to impose liability.

The new president conferred regularly with the bank president who gave substantial input concerning the mill's operation. *Id.* at 44. The court found the evidence insufficient to establish the bank controlled and managed the company. *Id.* at 46. Emphasizing that such conduct was a legitimate and customary practice in overseeing a debtor, the court refused to impose liability. *Id.*

Another early case exhibits a reluctance to impose liability on a lender under the agency theory. In American S. Trust Co. v. McKee, 173 Ark. 147, 293 S.W. 50 (1927), two creditor banks installed a manager in the debtor bank, who was contractually given complete authority to grant loans and collect collateral. *Id.* at 150-52, 293 S.W. at 52. In fact, this manager exercised substantial control over the debtor's operations. *Id.* at 155, 293 S.W. at 54. In dismissing liability, the court held that the acts of the manager which were beyond the authority outlined in the contract were not binding on the creditor banks. *Id.* at 162, 293 S.W. at 56.

33. *See supra* text accompanying notes 4-14.

34. The theories used to assert lender misconduct vary regarding the plaintiff's burden to establish lender liability. For example, breach of good faith places a lesser burden on the plaintiff to establish liability than the theories of breach of fiduciary duty or alter ego. Some theories are not easily adapted to the lender-borrower relationship. For example, breach of fiduciary duty or the instrumentality rule are not easily adapted to the lender-borrower relationship because they require such a high degree of creditor involvement to establish liability. *See infra* text accompanying notes 129-91.

35. Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

36. Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974).

37. For example, while the theory of liability for failure to exert potential control has been rejected, a recent case has added maladministration to the agenda of theories for asserting lender liability. *See supra* note 3 and *infra* text accompanying notes 62-79.

B. *Liability for Borrower's Negligence for Failure to Exercise Potential Control*

The California Supreme Court has imposed liability for the least amount of control exercised over a borrower.[38] The court found the lender liable for not exercising any control. In *Connor v. Great Western Savings & Loan Association*,[39] the court recognized a duty to exercise potential control.[40] In *Connor*, the lender financed an inexperienced real estate developer's land acquisition.[41] The real estate developer planned to construct a housing development on the land.[42] The lender, Great Western, and borrower agreed that the lender would have the right of first refusal to make loans to the home buyers.[43] Under the agreement, if an approved buyer obtained financing elsewhere and Great Western had offered the same loan terms, the real estate developer was required to pay Great Western the fees and interest earned by the other lender.[44]

The bank made the construction loan terms more favorable by failing to inquire into the faulty financial information received from

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38. Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).

39. *Id.*

40. *Id.* at 866, 447 P.2d at 617, 73 Cal. Rptr. at 378. While reasonably the potential, but unexercised control ought not give rise to liability because the creditor has gained no benefit through the exercise of control, there is some authority that mere potential for control will result in liability. *See supra* note 21. As discussed previously, the potential to control can result in liability under securities laws. *Id.* However, other courts impose liability for the mere potential to control, evidenced by covenants contained in loan agreements between the controlled and controlling party. *See, e.g.*, Nichols v. Arthur Murray, Inc., 248 Cal. App. 2d 610, 56 Cal. Rptr. 728 (1967) (franchisor held liable as principal to the controlled franchisee). In finding liability, the court stated that the agency relationship was established by the contract provisions which gave the franchisor extensive control over the franchisee. *Id.* at 614-15, 56 Cal. Rptr. at 731-32. *Accord* Wickham v. Southland Corp., 168 Cal. App. 3d 49, 55-59, 213 Cal. Rptr. 825, 829-31 (1985). However, the favored view is that actual control must be exercised to establish liability. *See In re* Prima, 98 F.2d 952 (7th Cir. 1938), *cert. denied*, 305 U.S. 658 (1939); Christoffel v. E.F. Hutton & Co., 588 F.2d 665 (9th Cir. 1978). *Christoffel* involved a suit against E.F. Hutton for misappropriation of estate assets. The court stated that although the concept of control is broad, it is not unlimited. Control requires some active participation by the controlling person in affairs of the controlled. *Id.* at 668. *See also* Burgess v. Premier Corp., 727 F.2d 826, 832-33 (9th Cir. 1984) (must have some showing of actual participation in the corporation's operations); Herm v. Stafford, 663 F.2d 669 (6th Cir. 1981); Metge v. Baehler, 577 F. Supp. 810 (S.D. Iowa 1984) (evidence must show that lender was active participant in the corporation's operation), *modified*, 762 F.2d 621 (8th Cir. 1985), *cert. denied*, 474 U.S. 1072 (1985).

41. *Conner*, 69 Cal. 2d at 858, 447 P.2d at 612, 73 Cal. Rptr. at 372.

42. *Id.*

43. *Id.*

44. *Id.* at 861, 447 P.2d at 614, 73 Cal. Rptr. at 374.

the developer and without following its normal procedure of reviewing construction plans before committing to the loan.[45] Nor did the bank examine the foundation plans or make construction recommendations.[46] After the housing development was constructed, the foundations of the homes began to crack causing serious damage. Because the foundations were improperly constructed they were unable to withstand the soil expansion.[47] The home buyers sued Great Western since the developer's financial resources were limited.

The California Supreme Court reversed the lower court's judgment of nonsuit granted in the lender's favor. While the supreme court found no joint venture existed[48] and therefore no vicarious liability, the court nevertheless found the lender owed a duty to the home buyers to exercise reasonable care to prevent defective construction.[49] In imposing this duty, the court determined Great Western had become more than a lender.[50] It had actively participated in the home construction business with the authority to exert extensive control over the business.[51] The court found the lender failed to reasonably exercise this control because it had not required soil tests, examined the foundations, or made suggestions to improve the building plans.[52]

The court also found public policy justified imposing this duty to exercise control.[53] The lender owed this duty primarily to its shareholders to protect the security for its long-term loans.[54] The court, however, expanded this duty to find the lender had an even stronger obligation to protect the home buyers.[55] The court reasoned that the typical home buyer was ill-equipped to discern such defects and lacked the financial capacity to remedy them.[56]

In dissent, Justice Mosk argued that imposing liability for failing to exercise control existed only in the presence of a special relation-

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45. *Id.* at 860, 447 P.2d at 613, 73 Cal. Rptr. at 373-74.
46. *Id.* at 860, 447 P.2d at 613, 73 Cal. Rptr. at 374.
47. *Id.* at 856, 447 P.2d at 611, 73 Cal. Rptr. at 371.
48. *Id.* at 863, 447 P.2d at 615, 73 Cal. Rptr. at 375.
49. *Id.* at 866, 447 P.2d at 617, 73 Cal. Rptr. at 378.
50. *Id.* at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.
51. *Id.*
52. *Id.*
53. *Id.* at 867, 447 P.2d at 618, 73 Cal. Rptr. at 378.
54. *Id.*
55. *Id.*
56. *Id.* For further discussion of the obligation to control another's actions to protect third parties, see Harper & Kime, *Duty to Control the Conduct of Another*, 43 YALE L.J. 886 (1934) (no mention of a creditor's duty to protect third parties from the debtor's misconduct); Note, *Failure to Rescue: A Comparative Study*, 52 COLUM. L. REV. 631 (1952).

ship.[57] No authority supported imposing a duty on the lender to control another's misconduct to prevent injury to third parties.[58] Moreover, the dissent contended the majority's finding that the lender had extensive control over the debtor was mythical.[59] The lender merely had the control to refuse to lend money.[60] Justice Mosk found the majority opinion implied that all lenders could be held to control the projects they financed.[61]

C. *The Future of Liability for Failure to Exercise Potential Control*

Interestingly, the Restatement of Torts does not recognize the debtor-creditor relationship as one generating control responsibilities.[62] Generally, courts recognize such a relationship only when overriding social policy concerns and some economic advantage to the controlling party are present.[63] In *Connor*, the lender received a fixed fee. The lender would not reap any reward had the project proved extremely profitable.[64] On the other hand, the developer, while exposed to many more risks and liabilities, could reap significant profits. The majority's position in *Connor*, however, found the lender to assume additional risks for which the lender received no corresponding reward. According to Justice Mosk, the majority drastically restructured traditional economic relationships.[65]

The *Connor* court's grounds for imposing liability on a control theory were weak. While social policy justifications existed, the accompanying economic advantages to the controlling party did not.[66] While the lender received some additional economic benefits, these benefits did not constitute profit sharing. Profit sharing would have justified

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57. 69 Cal. 2d at 874, 447 P.2d at 622, 73 Cal. Rptr. at 382.
58. *Id.*
59. *Id.* at 875, 447 P.2d at 623, 73 Cal. Rptr. at 383.
60. *Id.*
61. *Id.*
62. *See* RESTATEMENT (SECOND) OF TORTS §§ 316-319 (1977) (the relations between the actor and a third person which require the actor to control the third person's conduct); *id.* §§ 314A & 320 (the relations between the actor and another party which require the actor to control the conduct of third persons to protect the other party include innkeeper-guest, employer-employee, and land owner-licensee). *See generally* Harper & Kime, *supra* note 56.
63. Harper & Kime, *supra* note 56, at 331.
64. 69 Cal. 2d at 873, 447 P.2d at 622, 73 Cal. Rptr. at 382.
65. *Id.*
66. Although the profits of each were dependent on the overall success of the development, neither was to share in the profits or the losses that the other might realize or suffer. *See* Note, *The Expanding Scope of Enterprise Liability*, 69 COLUM. L. REV. 1084 (1969).

imposing risks and liabilities commensurate with those of the developer. Instead, the *Connor* court's analysis seems based on equitable principles and an evaluation of who is in a better position to bear the costs.[67] Since social and equity principles better justify the court's holding the case is unlikely to significantly restructure the control liability theory. In fact, the California Legislature subsequently amended their Civil Code to limit the *Connor* holding.[68] Consequently, both California courts and most courts around the country have read the case narrowly.[69] Lenders are exposed to liability only if they share in the profits earned by projects they financed.[70]

A Florida case exemplifies the *Connor* holding's limitations. In *Armetta v. Clevetrust Realty Investors*,[71] condominium purchasers asserted a claim against the construction lender similar to that in *Connor*.[72] The Fourth District Court of Appeal dismissed the complaint finding the mortgagee was not an active participant.[73] The court found the loan agreement's supervisory provisions were inserted to protect the lender and that a lender owed no duty to others to supervise projects it financed.[74] Finally, the court expressly rejected a broad interpretation of *Connor*.[75] Despite privity between the lender and a

67. The *Connor* court's finding of a duty rests on the court's conclusion that the homeowner did not occupy a position to protect against such defects. 69 Cal. 2d at 865-66, 447 P.2d at 617, 73 Cal. Rptr. at 377.

68. *See* CAL. CIV. CODE § 3434 (West 1970) which provides in pertinent part that:

> A lender who makes a loan of money, the proceeds of which are used . . . to finance the . . . improvement of real or personal property for sale or lease to others, shall not be held liable to third persons for any loss or damage occasioned by any defect in the real or personal property . . . unless such loss or damage is a result of an act of the lender outside the scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property.

Id. For further analysis of the *Connor* case and liability of construction lenders, see Comment, *Indirect Liabilities of Construction Lenders in a Development Setting*, 127 U. PA. L. REV. 1525 (1979).

69. *See, e.g.*, Armetta v. Clevetrust Realty Investors, 359 So. 2d 540 (4th D.C.A.), *cert. denied*, 366 So. 2d 879 (Fla. 1978). Liability has been limited to situations in which the creditor partakes of the profits realized by the financial project. *See* Skerlec v. Wells Fargo Bank, 18 Cal. App. 3d 1003, 96 Cal. Rptr. 434 (1971); Flamingo Drift Fishing, Inc. v. Nix, 251 So. 2d 316 (Fla. 4th D.C.A. 1971); Callaizakis v. Astor Dev. Co., 4 Ill. App. 3d 163, 280 N.E.2d 512 (1972). *Cf.* Blackwell v. Midland Fed. Sav. & Loan Ass'n, 132 Colo. 45, 284 P.2d 1060 (1955).

70. *See supra* note 64.

71. 359 So. 2d 540 (4th D.C.A.), *cert. denied*, 366 So. 2d 879 (Fla. 1978).

72. 359 So. 2d at 542.

73. *Id.* at 543.

74. *Id.*

75. *Id.*

purchaser, inspection provisions in the mortgage do not impose a duty on the lender to ensure proper construction.[76] This in effect vitiates the *Connor* holding.

Liability for failing to exercise control is not likely to expand given the Restatement's position,[77] and the California Legislature's[78] and other courts'[79] rejection of this liability theory. Arguably, courts have abandoned failure to exercise control as a lender liability theory.

D. *Liability Theories for Exercising of Excessive Control*

Excessive control over a borrower's businesses can result in lender liability for fraud, duress, or interference. Liability can arise if a lender excessively participates in any one particular aspect of a debtor's business.[80] Liability may result if the lender is on the board of directors, or participates in management or in the debtor's operations.[81] For instance, a court may hold a lender liable for profits lost under a management over which the lender has control.[82] Abuse of the control can invoke claims of fraud or duress which carry a steep price tag for punitive damages.[83]

State National Bank v. Farah Manufacturing Co.[84] is a recent case illustrating the application of these theories and their staggering costs. This case brought lender liability into the national spotlight when a jury returned a $19 million verdict against a lender. In *Farah*,[85] the borrower asserted claims for fraud, duress, and interference because of the lender's control over the debtor's board of directors and management. The borrower succeeded on all three counts.

The controversy centered on a management change clause in a $22 million dollar loan agreement between the Farah Manufacturing Company (FMC) and the lenders.[86] The clause allowed the lender to call

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76. *Id.*

77. *See supra* text accompanying note 62.

78. *See supra* text accompanying note 68.

79. *See supra* text accompanying note 69.

80. *See* D. ROME, *supra* note 23, at 8-10 to 8-13; Douglas-Hamilton, *supra* note 10.

81. *Id.*

82. State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984).

83. *See In re* Process Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984). Liability for excessive control differs from the agency and instrumentality theories in that more pervasive control is required under the agency or instrumentality theories.

84. The damage award in *Farah* of $18,947,348.77 challenged on appeal was affirmed with a reduction of $300,000. *Farah*, 678 S.W.2d at 667, 699.

85. 678 S.W.2d 661 (Tex. Ct. App. 1984).

86. *Id.* at 666-67.

the loan if a change in management was considered contrary to the lender's interests for any reason.[87] The parties signed the loan agreement just after Farah had been ousted from his position as CEO and president.[88] When company profits began to deteriorate, Farah sought to regain his position as CEO.[89]

The court based its decision on several factors. First, the lenders gave the FMC board of directors the impression that the loan would be called if Farah was reinstated as CEO.[90] The lenders, in reality, were undecided as to what they would do.[91] Second, the lenders blocked the election of two directors they felt Farah could control.[92] Third, many members elected to the board of directors, and the individual ultimately selected as CEO, had strong loyalties to FMC lenders.[93] For example, the lender previously employed the chairman of the board of directors.[94] Additionally, the CEO and another director served on the lender's board.[95] Fourth, when FMC continued to lose money, the lender requested FMC hire a specific consultant. This consultant was then elected CEO.[96] The consultant subsequently auctioned some FMC machinery and the proceeds were used to prepay FMC's debts to the lender.[97] Finally, the FMC board reinstated Farah as CEO and the company returned to profitability.[98]

The debtor based its cause of action for fraud on the lender's misrepresentation that it would call the loan if FMC reinstated Farah when the lender was unsure of its course of action.[99] FMC also based its duress claim on the lender's threat to foreclose on the loan if Farah were reinstated.[100] The court found the lender's warnings constituted duress because they caused "Farah and other board members to do what they would not have otherwise done."[101] Since the lender had the power to injure FMC's business and property interests, the FMC

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87. *Id.* at 667.
88. *Id.*
89. *Id.*
90. *Id.* at 667-68.
91. *Id.* at 670-71, 686.
92. *Id.* at 667.
93. *Id.* at 688, 690.
94. *Id.* at 668.
95. *Id.*
96. *Id.*
97. *Id.*
98. *Id.* at 669.
99. *Id.* at 680.
100. *Id.* at 683.
101. *Id.* at 686.

board occupied a vulnerable position. The court held that forcing a party to choose between undesirable and costly alternatives constitutes duress.[102] For example, duress exists when a party must bow to a lender's excessive demand or face bankruptcy, loss of credit rating, or loss of profits from a venture.[103] The lender had no right to issue such warnings when no evidence indicated that FMC's loan was in default or prospect of repayment was impaired.[104]

The debtor based the interference claim on the lender's actions which compelled the election of incompetent, inexperienced, and disloyal directors and officers.[105] Significantly, the CEO nominated by the lender sold assets to pay off part of FMC's loans, arguably to the detriment of FMC. *Farah* illustrates how liability can result from interlocking directorships when, in essence, the directors are serving two masters.

Liability based on division of loyalty can also arise when the lender forces a specific consultant on the borrower. For example, in *Credit Managers Association of Southern California v. Superior Court*,[106] the debtor alleged the bank threatened to call the loan unless the solvent debtor hired a business consultant.[107] The consultant, hired over the debtor's objection, allegedly assumed complete control and instituted restrictive practices without director or shareholder approval.[108] The California Court of Appeal found the complaint stated a cause of action against the lender. The decision was based on the fact that the consultant supplanted and overruled the board of directors.[109] The consultant could not rightfully assume this position when his allegiance was primarily to the lender.

Interference with the debtor's assets to the detriment of junior or unsecured creditors can also result in liability. In *In re Process-Manz Press, Inc.*,[110] the lender arranged for Process Manz to repurchase its

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102. *Id.*
103. *Id.*
104. *Id.*
105. *Id.* at 690.
106. 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975).
107. *Id.* at 355, 124 Cal. Rptr. at 244.
108. *Id.*
109. *Id.* at 359-60, 124 Cal. Rptr. at 247. *But see In re* Prima, 98 F.2d 952 (7th Cir. 1938). In *Prima*, the debtor's acquiescence in the bank's recommendation to hire a particular general manager was insufficient to constitute domination of the debtor's will, even though the bank threatened to call its outstanding loans in the event the debtor failed to comply. The court found the bank was not a fiduciary; therefore, its threat to call the loans was not overreaching but rather was a lawful exercise of the lender's legal right. *Id.* at 965.
110. 236 F. Supp. 333 (N.D. Ill. 1964).

outstanding preferred stock, in exchange for Process-Manz's canceling an inter-company debt of almost $3 million, which was owed by its parent.[111] The inter-company indebtedness arose when Process-Manz transferred loan proceeds received from the lender to its parent.[112] The repurchase eliminated a substantial asset of Process-Manz, $200,000 of working capital.[113]

The court upheld the referee in bankruptcy's order to subordinate the lender's entire claim against Process-Manz to the claims of Process-Manz's unsecured creditors.[114] The court reasoned the lender was not a secured creditor. Rather, the lender in essence owned Process-Manz since it had gained control of ninety percent of the company's stock pledged as security for the loan.[115] Subordination appears justified since the parent and lender conspired to use Process-Manz's assets for the parent's benefit to the unsecured creditors' detriment.[116]

Additionally, liability to the debtor's creditors can arise under a misrepresentation theory when a lender's conduct induces those creditors to extend credit to the common debtor.[117] In *Central States Stamping Co. v. Terminal Equipment Co.*,[118] one of the debtor's customers wished to hire the debtor to manufacture an expensive piece of equipment.[119] The customer telephoned the bank requesting information concerning the debtor's financial solvency.[120] The bank gave the customer a good report when, in reality, the debtor was in desperate financial straits.[121] The debtor did not use the customer's payments to

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111. *Id.* at 338-39.

112. *Id.*

113. *Id.* at 348.

114. *Id.* at 349.

115. *Id. Cf.* Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974). In evaluating the elements necessary to establish control under an instrumentality theory, the court stated that a dominant corporation's stock ownership in the subservient corporation does not per se resolve the ownership issue. *Id.* at 1104.

116. *See* Douglas-Hamilton, *supra* note 10, at 350. In *Farah*, the sale of assets coupled with influence on the debtor's board of directors triggered liability to the company itself. In *Process-Manz*, the stripping of vital assets alone was enough to trigger liability. However, liability was not limited to the debtor. *Process-Manz* illustrates how a lender may be held liable not only to the debtor, but also to third parties, such as, the debtor's other creditors.

117. General Motors Acceptance Corp. v. Central Nat'l Bank, 773 F.2d 771 (7th Cir. 1985); Central State Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405 (6th Cir. 1984); *see supra* note 7.

118. 727 F.2d 1405 (6th Cir. 1984).

119. *Id.* at 1406.

120. *Id.*

121. *Id.* at 1406-07.

begin manufacturing the equipment, but instead paid down the creditor bank's loan.[122] The court affirmed the lower court decision in favor of the customer. The court imposed a duty on the bank to respond honestly to the customer once it undertook to advise the customer of the debtor's financial condition.[123]

E. *The Future of the Excessive Control Liability Theories*

The success of the theories of fraud, duress, misrepresentation, and interference illustrates the courts' and juries' increased sensitivity to a borrower's interest in independent control of its business.[124] These theories equitably balance both the lender's and borrower's interests.[125] Lenders may protect their financial interests; however, they must also respect the interests of others.

Unlike the failure to exercise control theory in which a lender faces additional risks without the commensurate rewards,[126] these theories punish creditors who take unfair advantage of their position at another's expense.[127] Since these theories can reasonably apply to the lender-borrower relationship, borrowers will continue using them to retaliate against overreaching creditors. Lenders who fail to take heed will face harsh consequences.[128]

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122. *Id.* at 1407.

123. *Id.* at 1409.

124. This success is illustrated by the large judgments awarded against lenders. *See supra* note 1.

125. These theories better protect the borrowers' interest in controlling their own business affairs than the theories asserted in early cases. *See* cases cited *supra* note 32. The cases discussed earlier are more lenient toward lender's control or interference in the borrower's business affairs. For instance, the lender in *Chicago Mill* exercised influence in the election of the mill's officers. The loyalty of these newly elected officers, due to their affiliation with the creditor and their action taken as officers is questionable. In *Farah,* however, the borrower was able to attack just that type of lender misconduct using different theories. While the lender misconduct in *Farah* was arguably more egregious than the lender's conduct in *Chicago Mill,* this comparison illustrates the importance of choosing the proper theory under which to proceed. In view of the court's analysis, *Chicago Mill* was probably correctly decided.

These theories are not, however, one-sided. They also provide safeguards for lenders acting reasonably to protect their legitimate interests. *See supra* note 27.

126. *See supra* text accompanying notes 57-61.

127. *See supra* text accompanying note 22.

128. Lenders who fail to change lending practices to avoid liability under these theories will suffer due to the potential for punitive damages under these theories. Mitchell v. Ford Motor Credit Co., 688 P.2d 42 (Okla. 1984).

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F. *Fiduciary Relationships Between a Lender and Borrower*

Borrowers often assert that circumstances warrant finding a fiduciary relationship[129] between the lender and borrower.[130] The consequences of finding such a relationship are dramatic because the lender must put the borrower's interests first.[131] Imposing a fiduciary duty requires the lender to disclose confidential information not normally disclosed, and to refrain from self-dealing and other actions against the borrower's interests.[132] If a fiduciary relationship exists, a court may hold the lender responsible for all the debtor's obligations.[133] Further, a court may hold the lender liable in tort and require the lender to reverse its former dealings with the borrower.[134]

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129. In defining the term fiduciary relations, BLACK'S LAW DICTIONARY 564 (*5th* ed. 1979) states in pertinent part:

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

Id.

130. *In re* Letterman Bros. Energy Sec. Litig., 799 F.2d 967 (5th Cir. 1986); *In re* W.T. Grant Co., 699 F.2d 599 (2d Cir. 1983); *In re* Prima Co, 98 F.2d 952 (7th Cir. 1938); *In re* Teltronics Servs., Inc., 29 Bankr. 139 (Bankr. E.D.N.Y. 1983); Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985); Deist v. Wachholz, 678 P.2d 188 (Mont. 1984). *See also* D. ROME, *supra* note 23, ¶¶ 8.04, 8-18 to 8-19; Schechter, *supra* note 22, at 937-40.

131. A fiduciary is "[a] person having duty, created by his undertaking, to act primarily for another's benefit." BLACK'S LAW DICTIONARY 563 (5th ed. 1979). *See* Pepper v. Litton, 308 U.S. 295 (1939).

132. Cappello, *Banking Malpractice?,* CASE & COM. Sept.-Oct. 1986, at 3, 6.

133. Schechter, *supra* note 22, at 939.

134. *Id.* A lender may be found liable in tort for breach of fiduciary duty. For a fiduciary's standard of conduct, see Pepper v. Litton, 308 U.S. 295, 306-07 (1939). The finding of a fiduciary obligation can also subject the lender to attacks under a theory of constructive fraud, where a lender may be held liable for misrepresentations made without knowledge of their falsity. In Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985), the court found a quasi fiduciary relationship existed between a bank and depositor because banking performs an important public service, is a highly regulated industry, and the depositor depends totally on the bank for protection of those funds. This holding was expanded in Barrett

A fiduciary relationship can arise under various circumstances. For instance, the relationship can arise when a lender gives a borrower business advice or acts as the borrower's personal financial advisor.[135] Additionally, it may arise from interlocking directorships when a director simultaneously serves on both the lender's and borrower's boards.[136] When the lender serves on both boards, interests of the lender and borrower are especially likely to diverge.[137]

In *Deist v. Wachholz*, the Montana Supreme Court found the lender owed a fiduciary duty to a borrower.[138] In *Deist*, the vendor of a ranch and her husband dealt with the bank for twenty-four years prior to the husband's death.[139] After her husband's death, the wife-vendor reposed a trust on a bank officer who acted as her financial advisor respecting the ranch debt.[140] The bank officer did not disclose his membership in the partnership purchasing the ranch.[141] The court held the bank officer to a fiduciary standard which required the officer to insure the wife was not "insufficiently informed of some factor which could affect [her] judgment" in the sale of the ranch.[142]

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v. Bank of Am., 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16 (1986) where the court found the bank had become the debtor's fiduciary and could be held liable under a theory of constructive fraud for making false promises to release the debtor's guarantors after a proposed merger. *Id.* at 1369, 229 Cal. Rptr. at 20-21. Finally, in Deist v. Wachholz, 678 P.2d 188 (Mont. 1984), the court found the lender breached the fiduciary duty owed to the borrower by not considering the borrower's best interests. This breach amounted to constructive fraud. *Id.* at 198. For more on fiduciary duties in banking, see Hagedorn, *Fiduciary Aspects of the Bank-Customer Relationship*, 34 J. Mo. B. 406 (1978).

135. *See* Dennis v. BancOhio Nat'l Bank, No. 18738, slip op. (Perry County Ct. of Common Pleas, Ohio, Mar. 14, 1985) (*cited in*, Moss, *Borrowers Fight Back With Lender Liability*, A.B.A. J., Mar. 1, 1987, at 64, 67). In *Dennis*, a jury awarded a farmer $1.04 million offset by the loan amount of $700,000. The bank was found to have assumed a fiduciary relationship when it advised the farmer how to run the farm and the advice resulted in financial losses. *See also* Credit Managers Ass'n v. Superior Court, 51 Cal. App. 3d 352, 124 Cal. Rptr. 242 (1975). In *Credit Managers*, the lender installed a consultant over the borrower's objections. The court stated that the complete control over the debtor's operations assumed by the consultant could properly have led the trial court to conclude the consultant had a fiduciary obligation to the debtor, the debtor's creditors and to the debtor's stockholders. *Id.* at 359-60, 124 Cal. Rptr. at 247. *See also* Crystal Springs Trust Co. v. First State Bank, 732 P.2d 819 (former bank president and bank held liable for breach of fiduciary duty and fraudulent misrepresentation), *modified*, 736 P.2d 95 (Mont. 1987); Deist v. Wachholz, 678 P.2d 188 (Mont. 1984) (lender owed fiduciary duty to borrower for assuming the role as the borrower's financial advisor).

136. D. ROME, *supra* note 23, at 8-11.

137. *Id.*

138. 678 P.2d 188 (Mont. 1984).

139. *Id.* at 193.

140. *Id.* at 194.

141. *Id.* at 192.

142. *Id.* at 195 (quoting Lloyds Bank, Ltd. v. Burdy, 3 All. E.R. 757, 768 (1974)). The court found substantial evidence existed that the contract terms favored the partnership, in

Most courts, however, are reluctant to hold a creditor to a fiduciary standard.[143] In *In re Teltronics Services, Inc.*,[144] certain loan agreement covenants required Teltronics to purchase equipment from the lender and restricted its outside financing to a predetermined level while the loans remained outstanding.[145] The court found these restraints did not give the lender control over the borrower's lifeline.[146] In finding that no fiduciary relationship existed, the court stated the loan agreement covenants were not unusual and the creditor's careful watch over the debtor's financial situation was not inherently wrong.[147]

Moreover, the court held that a creditor is generally not the debtor's fiduciary.[148] A fiduciary relationship exists only when a creditor exercises such extensive control that it amounts to domination of a debtor's will.[149] No such merger of identity existed between the lender and Teletronics since "[the lender] owned no stock, had no contractual right to participate in management, and shared no common officers or directors with Teltronics."[150] Instead, the lender's actions exhibited sound business judgment to protect the lender's financial interests.[151]

G. *The Future of Fiduciary Relationships in the Lender-Borrower Relationship*

While courts often suggest a fiduciary relationship between a lender and borrower exists,[152] courts rightly have been reluctant to impose

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which the bank officer was a member, at the expense of the borrower. *Id.* at 198. The court found the bank officer breached his fiduciary duty and did not consider the borrower's best interests. *Id.*

143. *In re* W.T. Grant Co., 699 F.2d 599, 609-10 (2d Cir. 1982), *cert. denied*, 464 U.S. 822 (1983); Weinberger v. Kendrick, 698 F.2d 61, 78-79 (2d Cir. 1982), *cert. denied*, 464 U.S. 818 (1983); Ingram v. Lehr, 41 F.2d 169, 170 (9th Cir. 1930); Crowder v. Allen-West Comm'n Co., 213 F. 177, 184 (8th Cir. 1914).

144. 29 Bankr. 139 (Bankr. E.D.N.Y. 1983).

145. *Id.* at 172.

146. *Id.*

147. *Id.*

148. *Id.* at 170.

149. *Id.*

150. *Id.* at 172.

151. *Id.* The lender had imposed payment terms on Teltronics and had declined to provide additional financing. *Id.* In addition, the lender had closely monitored Teltronics' financial position and had recommended that Teltronics scale down its growth projections. *Id.*

152. *See, e.g.*, Commons v. Schine, 35 Cal. App. 3d 141, 110 Cal. Rptr. 606 (1973). In *Commons*, the court stated that "[t]he corporate controller-dominator is treated in the same manner as a director of an insolvent corporation and thus occupies a fiduciary relationship to its creditors." *Id.* at 144, 110 Cal. Rptr. at 608.

such a relationship.[153] Using the fiduciary relationship as an analytical method has created a confusing conglomeration of cases.[154] These cases have been criticized for failing to explain the basis of creditor control liability and failing to supply a consistent precedent for any proposed rule.[155] As a result, judicial time is often wasted determining whether a particular relationship falls within the category of this special relationship.[156]

Some courts recognize the practical problems associated with imposing a fiduciary duty on a lender.[157] Such a relationship contradicts the relative positions lenders and borrowers ordinarily assume.[158] Generally, lending relationships are the result of arm's-length bargaining. Thus, obligating a lender to act as a fiduciary for interests on the opposite side of the negotiating table is illogical.[159]

To find a fiduciary relationship, the lender-borrower relationship should exhibit particular circumstances deserving special protection.[160] Only when a lender merges with the identity of the borrower does the lender join the borrower's entrepreneurial effort and enjoy the corresponding economic benefits.[161] The corresponding economic reward from such pervasive involvement sufficiently justifies imposing a special obligation.[162] In light of the chilling consequences,[163] a lesser standard would be inequitable.[164] Lenders should not be deterred from

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153. *See* Symons, *The Bank-Customer Relation: Part II — The Judicial Decisions*, 100 BANKING L.J. 325, 331 (1983). For cases refusing to find a fiduciary relationship between a debtor and creditor, see Delta Diversified, Inc. v. Citizens & S. Nat'l Bank, 171 Ga. App. 625, 320 S.E.2d 767 (1984) (no confidential relationship between bank and customers); Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985).

154. *See* Symons, *supra* note 153, at 332.

155. *See* Schechter, *supra* note 22, at 940.

156. Symons, *The Bank-Customer Relation: Part I -- The Relevance of Contract Doctrine*, 100 BANKING L.J. 220, 225 (1983).

157. *See, e.g.*, Weinberger v. Kendrick, 698 F.2d 61, 79 (2d Cir. 1982), *cert. denied*, 464 U.S. 818 (1983).

158. *Id.*

159. *Id.*

160. *See* Deist v. Wachholz, 678 P.2d 188, 193 (Mont. 1984) (special relationship by showing customer reliance for many years); Symons, *supra* note 156, at 225.

161. *See* Bartlett & Lapatin, *The Status of a Creditor as a "Controlling Person,"* 28 MERCER L. REV. 639, 655-57 (1977). Under this framework, the court's holding in *Deist* can perhaps be justified. The bank officer's economic gain from participating in the ranch purchase arguably justified his cast in a new role.

162. *Id.*

163. *See supra* text accompanying notes 131-34.

164. Like the liability theory for failure to exercise control, a lesser standard for finding a fiduciary duty exists would subject a lender to additional risks without the commensurate reward for the risk assumption. *See supra* text accompanying notes 62-67.

some involvement with the borrower to protect their financial interests. Indeed, such inactivity would violate the duty owed to the lender's own creditors and equity holders.[165]

Courts should require complete domination or merger of interests to impose a fiduciary obligation. Requiring the lender and borrower's interests to merge mitigates the practical problems inherent in imposing a fiduciary obligation on a lender. If the lender so pervades the borrower's business, they no longer occupy opposite sides of the negotiating table.[166]

Borrowers should note the heavy burden necessary to impose a fiduciary obligation on a lender.[167] For this reason, resort to the excessive control liability theories will likely be more appropriate to combat lender misconduct.[168] This approach is more consistent with the basic nature of the debtor-creditor relationship.

H. *Liability Under the Alter Ego or Instrumentality Theory*

Another theory used to assert lender liability is the alter ego or instrumentality theory. Under this theory, damages are not limited to those incurred during the controlling period. Rather, an alter ego is liable for all the dominated entity's obligations, both in contract and tort.[169] Like the standard of liability imposed on the lender under the

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165. *In re* W.T. Grant Co., 699 F.2d 599, 610-11 (2d Cir.), *cert. denied*, 464 U.S. 822 (1983).

166. Since this standard is similar to that imposed under the instrumentality theory, the cases decided under the instrumentality theory can provide valuable guidance for the application of the fiduciary obligation to the lender-borrower context. *Cf. In re* Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973) (only when a lender completely dominates the borrower will liability result under the instrumentality rule), *modified* 490 F.2d 916 (5th Cir. 1974); Teltronics Servs., Inc., 29 Bankr. 139 (Bankr. E.D.N.Y. 1983) (lender must dominate the will of debtor for a fiduciary obligation to arise). Since the consequences of finding a fiduciary duty surpass those resulting under the instrumentality rule, it has been suggested that a stricter standard than that imposed under the instrumentality rule be required before a fiduciary duty is found. Schechter, *supra* note 22, at 938-39. Under the instrumentality rule, an alter ego may be held responsible for all the debtor's obligations no matter when they arise. *Id.* at 939. However, a fiduciary may also be liable in tort and be required to reverse former dealings with the debtor. *Id.*

167. *In re* Teltronics Servs., Inc., 29 Bankr. 139, 170 (Bankr. E.D.N.Y. 1983). *See also* Edwards v. Northwestern Bank, 39 N.C. Ct. App. 261, 250 S.E.2d 651 (N.C. Ct. App. 1979). In *Edwards*, the court stated that a "fiduciary duty arises only when the evidence establishes that the party providing financing to a corporation completely dominates and controls its affairs." *Id.* at 277, 250 S.E.2d at 662.

168. *See supra* text accompanying notes 124-28.

169. *See* H. BALLENTINE & G. STERLING, CALIFORNIA CORPORATION LAW § 296.01 n.5 (1949).

fiduciary theory,[170] the standard for liability under the instrumentality theory requires complete domination.[171]

Recent litigation exemplifies the broader latitude extended a lender under the alter ego theory. In *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,[172] the plaintiffs were creditors of the insolvent debtor.[173] The plaintiffs sued National Distillers, the parent of the Bridgeport Brass Company (Brass), the debtor's major supplier.[174] Brass had changed the debt from an unsecured obligation to a secured note.[175] When the debtor experienced financial difficulty, National Distillers agreed to provide additional funding and internal financial management assistance.[176] The creditor sent one of its internal auditors to the debtor's premises to oversee the debtor's finances. The creditor further agreed to assist the debtor in liquidating unprofitable assets to provide working capital.[177] In return, the debtor executed notes for amounts due and secured them with various assets, including capital stock of various corporations it owned. Despite these efforts, the debtor ceased operations.[178]

The Fifth Circuit Court of Appeals affirmed the trial court decision that insufficient evidence existed to establish a jury question on the control issue.[179] The court held liability under the instrumentality rule requires significant facts indicating the creditor assumed actual, participatory, total control of the debtor.[180] Active involvement in the debtor corporation's management did not automatically constitute liability.[181] The court then concluded that liability under the instrumentality theory requires total domination, preventing the subservient corporation from enjoying any independent corporate interests.[182] Finally, fraud or injustice must result from misuse of the control.[183]

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170. *See supra* text accompanying note 149.
171. Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098, 1106 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974).
172. 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974).
173. 483 F.2d at 1101.
174. *Id.* at 1108-09.
175. *Id.* at 1107.
176. *Id.* at 1108.
177. *Id.*
178. *Id.* at 1109.
179. *Id.* at 1114.
180. *Id.* at 1105.
181. *Id.*
182. *Id.* at 1106.
183. *Id.*

Under this framework, the court found National's shared responsibility for some, but not all aspects of the debtor's operation insufficient to impose liability.[184] The court also found National's power to exert substantial pressure on the debtor inherent in any debtor-creditor relationship.[185] Power alone does not constitute control under the instrumentality rule.[186]

I. *The Future of the Instrumentality Theory in the Lender-Borrower Relationship*

The alter ego or instrumentality theory developed from corporate law.[187] Historically, courts have employed the theory to disregard the corporate fiction, imposing liability on shareholders and parent companies for obligations of the corporation they control.[188] Because a corporation is designed primarily to shelter shareholders and corporate officers from liability,[189] the stringent standard of complete domination under this liability theory seems justified.[190] In contrast, the lender-borrower is a contractual relationship where the need to shelter persons from liability does not exist. Despite the absence of the need to shelter the lender from liability, the stringent standard retains its vitality through precedent and, thus will be applied to determine lender liability.

Consequently, borrowers carry a heavy burden to establish liability under this theory.[191] *Krivo* illustrated this burden where even the

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184. *Id.* at 1112.

185. *Id.* at 1114.

186. *Id.*

187. *See generally* 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 43-43.60 (perm. ed. 1963).

188. *Id.*

189. For reasons justifying corporations' limited liability, see Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 507-09 (1976) (a corporation's creditors are in a better position to appraise the risks of extending the corporation credit than are its shareholders). *See also* Halpern, Trebilock, & Turnbull, *An Economic Analysis of Limited Liability in Corporate Law*, 30 U. TORONTO L.J. 117 (1980). *But see* Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589 (1975).

190. Krivo Indus. Supply Co. v. National Distillers & Chem. Corp., 483 F.2d 1098 (5th Cir. 1973) (the instrumentality rule requires complete domination so that the subservient entity maintains no separate interests and operates only to achieve the goals of the dominant corporation), *modified*, 490 F.2d 916 (5th Cir. 1974).

191. *See id.* at 1106 (quoting 1 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 43 (perm. ed. 1963)) (to establish liability under the instrumentality theory, borrowers must establish that the lender controlled the borrower and that they no longer retained a separate existence). Professor Fletcher states:

lender's substantial influence and pressure on the debtor did not lead to liability. Given the instrumentality theory's historical development and stringent standard, the theory is not likely to greatly expand lender liability.

III. Lender Liability for Breach of Good Faith

A developing branch of case law holds lenders liable for breaching the obligation of good faith implied in every contract through the Uniform Commercial Code section 1-203.[192] U.C.C. § 1-201(19) defines good faith as honesty in fact.[193] In essence, good faith requires that parties cooperate so that neither will be deprived of reasonable expectations.[194]

The concept of good faith is not new. Classical Roman law recognized good faith[195] and English courts applied it to the English law merchant.[196] Today, the Uniform Commercial Code, which is the law in all states except Louisiana, expressly adopts the concept.[197] The

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> The control necessary to invoke what is sometimes called the "instrumentality rule" is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal.

1 W. Fletcher, Cyclopedia of the Law of Private Corporations § 43.10 (perm. ed. 1983).

192. U.C.C. § 1-203 (1978) provides that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." Louisiana is the only state which has failed to adopt the Uniform Commercial Code.

193. U.C.C. § 1-201(19) (1978) states " 'Good faith' means honesty in fact in the conduct or transaction concerned." *Id.*

194. Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code,* 30 U. Chi. L. Rev. 666, 669 (1963).

195. Roman law implied a general obligation of good faith in the performance of informal consensual contracts much like the U.C.C. does today. *See* F. Lawson, A Common Lawyer Looks at the Civil Law 124-25 (1955).

196. English law used good faith in connection with both good faith performance and good faith purchase. Farnsworth, *supra* note 194, at 670. The U.C.C. adopts this approach implying a general obligation of good faith performance through U.C.C. § 1-203 and an obligation of good faith purchase through, for example, U.C.C. §§ 2-403(1) and 3-302. For more on good faith purchase generally, see Gilmore, *The Commercial Doctrine of Good Faith Purchase,* 63 Yale L.J. 1057 (1954). For a general overview of the history behind the adoption of the good faith obligation into the U.C.C., see Farnsworth, *supra* note 194. The U.C.C. uses the good faith obligation in two senses, good faith purchase and good faith performance. The obligation of a good faith purchase is generally concerned with a state of mind, a subjective inquiry. In contrast, the obligation of good faith in performance evaluates the reasonableness or fairness of the performance, an objective standard. *Id.*

197. 1 Uniform Commercial Code (U.L.A.) 1 (1976). Restatement (Second) of Contracts § 205 (1981) also imposes the duty of good faith. The Restatement provides "[e]very

entrance of good faith into the banking industry, however, is new. While a few courts used this theory to assert lender liability in the mid-sixties,[198] breach of good faith has only recently gained widespread prominence in asserting lender misconduct.[199]

Generally, courts apply the good faith obligation in two areas. First, courts may obligate a lender to exercise discretion in good faith. The typical loan agreement allows the lender to exercise discretion to determine when to accelerate a loan.[200] For example, loan agreements often include acceleration clauses allowing the lender to accelerate when the loan becomes insecure.[201] Other clauses specify an event upon which default will occur, such as upon sale[202] or lease[203] of the collateral. U.C.C. § 1-208 imposes a good-faith duty on a lender de-

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contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." *Id.*

198. *See, e.g.*, Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964) (obligation of good faith breached when lender lulled a borrower into a false sense of security and then accelerated); Fort Knox Nat'l Bank v. Gustafson, 385 S.W.2d 196 (Ky. Ct. App. 1964) (lender may accelerate debt when it deems itself insecure, but the insecurity must be reasonable and not made in bad faith).

199. *See, e.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).

200. The lender's discretion is most evident when the loan agreement contains an acceleration clause under which the lender can accelerate when he deems himself insecure. U.C.C. § 1-208 (1978) imposes a duty of good faith on the lender's exercise of such a clause. U.C.C. § 1-208 provides:

> A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

Id.

201. *See supra* note 200. For cases which assert a lender's breach of good faith for declaring a loan in default or terminating a line of credit, see K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (lender liable for failing to give prior notice before refusing to extend funds under a line of credit); Midatlantic Nat'l Bank v. Commonwealth Gen., Ltd., 386 So. 2d 31 (Fla. 4th D.C.A. 1980) (lender justified in terminating line of credit due to bankruptcy of debtor's subsidiary and, therefore, did not breach obligation of good faith); First Nat'l Bank v. Twombley, 689 P.2d 1226 (Mont. 1984) (lender could be held liable for punitive damages for breach of good faith when one bank officer offset against a borrower's account after another officer had agreed to convert the loan to an installment obligation); Yankton Prod. Credit Ass'n v. Larsen, 219 Neb. 610, 365 N.W.2d 430 (1985) (case remanded for a determination of whether lender acted in bad faith in refusing to make loans to finance the borrower's expansion of his livestock operations).

202. Brummund v. First Nat'l Bank, 99 N.M. 221, 656 P.2d 884 (1983).

203. Brown v. Avemco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979).

claring default under an insecurity clause.[204] Courts, however, have distinguished between insecurity clauses and default clauses, which place control of the event causing default with the debtor.[205] When the debtor has control over the event, good faith is inapplicable.[206]

Second, courts imply an obligation of good faith when the lender and borrower establish a course of dealing which varies with the express loan terms.[207] The borrower may rely on this pattern of lender conduct believing it has more time to pay the loan or cure a default.[208] In these circumstances, the courts generally require the lender to notify the borrower before taking any action against the loan.[209]

The broad nature of the U.C.C. good faith provision has led to inconsistent applicaton. Courts differ on whether the obligation of good faith should apply to a creditor's decision to call a demand note.[210] Further, courts continue to disagree whether to evaluate a creditor's actions by a subjective or objective standard of good faith.[211]

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204. *See supra* note 200.

205. Abrego v. United Peoples Fed. Sav. & Loan Ass'n, 281 Ark. 308, 664 S.W.2d 858 (1984); Bowen v. Danna, 276 Ark. 528, 637 S.W.2d 560 (1982); Hickmon v. Beene, 6 Ark. App. 272, 640 S.W.2d 812 (1982); Brummund v. First Nat'l Bank, 99 N.M. 221, 656 P.2d 884 (1983); *In re* Sutton Inv., Inc., 46 N.C. App. 654, 266 S.E.2d 686 (1980).

206. *See, e.g.*, Bowen v. Danna, 276 Ark. 528, 637 S.W.2d 560 (1982); Hickmon v. Beene, 6 Ark. App. 272, 640 S.W.2d 812 (1982).

207. This situation can arise when a lender accepts late payments. Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983).

208. *See, e.g.*, Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964). In *Skeels*, the lender financed the borrower's automobile inventory. *Id.* at 848. Upon discovery that several cars had been sold out of trust, the lender repossessed the inventory effectively destroying the borrower's business. *Id.* at 851. The lender was found liable for his persistent assurances of further advances and quick actions in contradiction with those statements in its repossession of the inventory. *Id.* However, an award of punitive damages was reversed. *Id.* at 852.

209. For cases finding the obligation of good faith implied a notice requirement, see K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985); Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964); Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983); Cobb v. Midwest Recovery Bureau Co., 295 N.W.2d 232 (Minn. 1980).

210. K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (good faith applies to decision of whether to call a demand note). For cases finding good faith inapplicable to demand notes, see Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336 (Fla. 3d D.C.A. 1986); Fulton Nat'l Bank v. Willis Denney Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980); Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985).

211. The controversy surrounding the proper standard for good faith originated in England with Lawson v. Weston, 4 Esp. 56, 170 Eng. Rep. 640 (K.B. 1801). *Weston* applied a subjective standard introducing the test of the pure heart and empty head. Another case, Gill v. Cubitt, 3 B. & C. 466, 107 Eng. Rep. 806 (K.B. 1824), discarded the subjective test and replaced it with the reasonable man standard, an objective test. In 1836, *Gill* was overruled by Goodman

This section will first examine the application of good faith to demand notes. Next, this section will highlight typical lender actions which have led to liability for breach of good faith. Specifically, discretionary decisions and courses of conduct causing lender liability will be concisely reviewed.

A. *Application of Good Faith to Demand Notes*

The good faith concept received widespread recognition as a basis for asserting lender liability in *K.M.C., Inc. v. Irving Trust Co.*[212] *K.M.C.* represents the most expansive application of the good faith concept. In *K.M.C.*, Irving Trust Co. appealed from a $7.5 million[213]

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v. Harvey, 4 A. & E. 870, 111 Eng. Rep. 1011 (K.B. 1836). In 1857, the United States Supreme Court decided to follow *Goodman* which instituted the subjective standard into the United States. *See* Goodman v. Simonds, 61 U.S. (20 How.) 343 (1857).

Today, alternating between subjective and objective standards continues. Under the subjective standard, a lender must only honestly believe the debtor's financial condition has deteriorated and correctness of the belief is irrelevant. Under the objective standard, the lender must reasonably believe this with the reasonableness of his belief measured by circumstantial events. Other lenders in the same situation should be inclined to the same belief. The standard applied, however, may be of little significance since a jury operating under a subjective standard will consider the reasonableness of the belief in determining its honesty. However, the standard applied may affect the proof supplied to evaluate the belief. For cases advocating a subjective standard, see Quest v. Barnett Bank, 397 So. 2d 1020 (Fla. 1st D.C.A. 1981); Karner v. Willis, 238 Kan. 246, 710 P.2d 21 (1985). For cases adopting an objective standard, see K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985); Brown v. Avemco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979). When the U.C.C. was presented for adoption in 1952, the reasonable commercial standard had been removed from the good faith general definition in § 1-203. The removal had been suggested by the American Bar Association's Section of Corporation, Banking and Business Law. *See* FARNSWORTH, *supra* note 194, at 673.

212. 757 F.2d 752 (6th Cir. 1985).

213. In *K.M.C.*, the lenders objected to the damages as excessive because K.M.C.'s value was less than the jury's award of $7,500,000. *Id.* at 766. The appraiser in the case based his valuation on K.M.C.'s projected performance following acquisition by a larger company, not on what it would have done had it remained privately owned. *Id.* at 764. In doing this the appraiser built into his valuation certain assumptions with respect to advantages enjoyed by larger over mid-sized companies. *Id.* The court responded that since the jury could have determined that K.M.C. would have been valued by larger companies based on these assumptions, the appraiser's approach was acceptable. *Id.* The court further stated that

> [w]e are not insensitive to Irving's complaint that K.M.C.'s value on March 1, 1982, was less than the jury's award of $7,500,000. It is plain from the record that the company was heavily leveraged, its heavy losses in 1981 had eroded stockholder equity, and it had a substantial amount of uncollectible receivables in excess of its bad debt reserve. Nevertheless, the Magistrate concluded that the damage award was not outside the limits of the reasonable range, and we are constrained to agree.

Id. at 766.

jury[214] verdict in favor of K.M.C., a wholesale and retail grocery business.[215] Irving and K.M.C. had entered into a financing agreement in which Irving held a security interest in all of K.M.C.'s accounts receivable and inventory.[216] In exchange, Irving granted K.M.C. a $3.5 million line of credit with funds to be advanced at Irving's discretion.[217] The financing agreement also contained a payable on demand provision.[218]

K.M.C. claimed Irving's refusal to advance funds was in bad faith and destroyed K.M.C.'s business.[219] Because a bank officer believed K.M.C.'s business was collapsing the bank denied a request for an advance well within the $3.5 million limit.[220] Irving admitted, however, to being fully secured on the day it refused the advance to K.M.C.[221] Three days later, Irving resumed financing.[222] Nevertheless, K.M.C.'s business failed.[223] K.M.C. based its damages on this three day gap in financing.[224]

The Sixth Circuit affirmed the jury award finding good faith required Irving to notify the borrower to allow sufficient time to seek

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214. The loan agreement between Irving and K.M.C. contained a jury waiver provision stating that each party "waives all right to a trial by jury in any action or proceeding relating to transactions under this Agreement." *Id.* at 755. Nevertheless, K.M.C. was held entitled to a jury. In reaching this decision, the court noted that the right to jury trial is governed by federal not state law. *Id.* The right may only be waived if done "knowingly, voluntarily and intentionally." *Id.* K.M.C. contended that its consent to this provision was not done knowingly and voluntarily since before signing the agreement Irving represented to the K.M.C. president that the waiver provision would not be enforced absent fraud, which was not present in the K.M.C. case. This statement was sufficient to show K.M.C. had not consented knowingly and voluntarily. In addition, the court held this statement admissible despite the parol evidence rule due to the unique nature of the bargain as one involving waiver of a constitutional right. In this situation, the court found that the parol evidence rule should not be rigidly applied. *Id.* at 757 n.5. The parol evidence rule may bar statements made by bank representatives when constitutional rights or fraud are not involved. *See, e.g.*, Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985) (The borrowers alleged the lenders made representations that if the borrowers signed personal guarantees, the lender would extend further credit and not call the note due. The court held this separate oral agreement inadmissible under the parol evidence rule.).

215. *K.M.C.*, 757 F.2d at 754.

216. *Id.*

217. *Id.*

218. *Id.* at 759.

219. *Id.* at 754.

220. *Id.*

221. *Id.* at 761.

222. *Id.* at 762.

223. *Id.* at 754.

224. *Id.* at 762.

alternative financing.[225] The court rejected Irving's argument that requiring notice would be inconsistent with the agreement provisions making the loan payable on demand.[226] The court found the good faith obligation limited Irving's discretion to advance and its power to demand repayment.[227]

The *K.M.C.* court's application of good faith to demand notes has been viewed as suspect.[228] However, the financing arrangement which gave Irving substantial power over K.M.C. arguably justifies the decision.[229] Under the financing arrangement, K.M.C. deposited all its receipts into an account to which Irving had sole access.[230] If Irving refused to lend funds K.M.C. would be left without operating capital until it paid its loan.[231] Without the implied obligation of good faith, the court found K.M.C.'s continued existence was left entirely to the whim of Irving.[232]

Not all courts have applied the good faith obligation so expansively.[233] Many courts have rejected the *K.M.C.* application of good

225. *Id.* at 759. The court found notice to the borrower was required "absent valid business reasons precluding Irving from doing so." *Id.* Moreover, these business justifications would be evaluated objectively. *Id.* at 761.

226. *Id.* at 759. Irving raised several issues on appeal. Irving claimed that 28 U.S.C. § 636(c) (1985), which permits a magistrate to conduct a civil trial upon the parties' consent, was unconstitutional. Irving also claimed that the magistrate should not have granted K.M.C. a jury trial and the magistrate admitted incompetent expert testimony on the issue of damages. *Id.* at 755. Finally, Irving asserted it acted in good faith and therefore did not breach the financing agreement. *Id.* at 754-55. The court rejected each of these claims. *Id.* at 755, 758-59, 764.

227. *Id.* at 760.

228. *See* Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336 (Fla. 3d D.C.A. 1986).

229. Further, the court based its holding on the lender's failure to notify the borrower before refusing to advance funds. *K.M.C.*, 757 F.2d at 759. Consequently, the court's finding that good faith applies to the demand for repayment is dicta.

230. *Id.*

231. *Id.*

232. *Id.* The court stated, "if a notice was requisite to [the agreement's] proper execution, a convenant to give such notice will be inferred, for any other construction would make the contract unreasonable, and place one of the parties entirely at the mercy of the other." *Id.* (quoting Wells V. Alexandre, 130 N.Y. 642, 29 N.E. 142, 143 (1891)).

233. *See, e.g.*, English v. Fischer, 660 S.W.2d 521 (Tex. 1983) (criticizing the imposition of good faith to loan convenants). The court stated

> This concept is contrary to our well-reasoned and long established adversary system which has served us ably in Texas for almost 150 years. Our system permits parties who have a dispute over a contract to present their case to an impartial tribunal for a determination of the agreement as made by the parties and embodied in the contract itself. To adopt the laudatory sounding theory of "good faith and fair dealing" would place a party under the onerous threat of treble damages should he seek to compel his adversary to perform according to the contract terms as

faith to demand notes.[234] In *Centerre Bank v. Distributors, Inc.*,[235] the bank sued the loan guarantors to recover a deficiency,[236] and the guarantors counterclaimed alleging bad faith, misrepresentation, breach of fiduciary duty, prima facie tort, and breach of an oral contract to continue to extend credit.[237] The jury awarded the guarantors more than $7.5 million.[238]

The Mississippi Court of Appeal reversed, holding the good faith obligation inapplicable to demand instruments.[239] Because the borrower by his signature unconditionally agreed payment was immediately due, the borrower could not contest the lender's decision to demand pay-

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> agreed upon by the parties. The novel concept advocated by the courts below would abolish our system of government according to settled rules of law and let each case be decided upon what might seem "fair and in good faith," by each fact finder. This we are unwilling to do.

Id. at 522.

234. *See, e.g.*, Flagship Nat'l Bank v. Gray Distribution Sys., Inc., 485 So. 2d 1336 (Fla. 3d D.C.A. 1986) (*see infra* notes 243-51 and accompanying text); Fulton Nat'l Bank v. Willis Denny Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980) (court of appeals held that good faith did not limit a bank's power to seek payment on a demand note); Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985) (*see infra* notes 235-42 and accompanying text); Allied Sheet Metal Fabricator, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 536 n.5, 518 P.2d 734, 738 n.5 (good faith under a state statute equivalent to U.C.C. § 1-203 is not a factual issue in determining a bank's right to call a demand note), *cert. denied*, 419 U.S. 967 (1974).

235. 705 S.W.2d 42 (Mo. Ct. App. 1985).

236. *Id.* at 44.

237. *Id.* at 44, 51, 53.

238. 705 S.W.2d at 44. The attorney for the defendants, James Wirken of Spradley & Wirken in Kansas City, stated that defendants would have been satisfied if just the debt had been canceled. Swartz, *supra* note 2, at 19. As in *Centerre*, juries may hit lenders with multimillion-dollar verdicts even when the borrowers are not pressing for them. *Id.*

239. 705 S.W.2d at 48. The plaintiffs alleged fraudulent inducement in signing the guarantees due to the representation that the bank would not call the loan, but continue to extend credit. *Id.* at 48-49. The court of appeal found that the plaintiffs were aware that the bank officer making the statement was contingent on a loan committee's approval. *Id.* at 50. Hence, the court found none of the plaintiffs had been misled by the loan officer's statement. *Id. But cf.* First Nat'l Bank v. Twombley, 689 P.2d 1226 (Mont. 1984) (lender breached good faith when one loan officer offset against a borrower's account after another loan officer had agreed to convert the loan to an installment program). On the fiduciary claim, the *Centerre* court found that the relationship between the plaintiffs and the bank was merely that of a borrower and a lender. 705 S.W.2d at 53. The court stated that no confidential or fiduciary relationship exists between a lender and borrower of funds. *Id.* On the prima facie tort claim, the court found the lenders had a valid business reason for calling the note due and this was sufficient to defeat the tort claim. *Id.* at 54. Finally, on the oral contract claim, the court held that the personal guarantees were fully integrated agreements and so evidence of an oral contract violated the parol evidence rule. *Id.* at 52.

ment at any time as being in bad faith.[240] Imposing the good faith obligation to a demand note, in effect, added a term to the agreement the parties did not contemplate.[241] The court refused to rewrite the terms of the agreement.[242]

In *Flagship National Bank v. Gray Distribution Systems, Inc.*,[243] the Florida Third District Court of Appeal went further than *Centerre* by limiting the extent to which a course of conduct may modify a loan agreement. In *Flagship*, the lender appealed a nonjury trial court verdict in favor of the corporate borrowers and individual guarantors.[244] During a workout, the corporate borrower signed a $400,000 demand note under which the borrower could not disburse funds without first obtaining lender approval.[245] Over a four month period, the lender advanced funds in excess of the loan amount.[246] The trial court found that during this four month period the parties' course of dealings modified the loan agreement, binding the lender to continue extending credit above the loan amount.[247]

The Florida Third District Court of Appeal reversed the trial court finding good faith inapplicable to a demand note.[248] The court recognized that under certain circumstances a course of conduct may modify a written agreement.[249] However, when the pattern of conduct contradicts the agreement express terms such that a consistent construction cannot be drawn, the terms of the written agreement prevail.[250]

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240. 705 S.W.2d at 48.

241. *Id.*

242. *Id.* The facts revealed that the lender had given the borrower several months' notice that the loan would be called and had worked with the borrower in an attempt to obtain alternate financing. *Id.* at 46. This probably influenced the court's holding.

243. 485 So. 2d 1336 (Fla. 3d D.C.A. 1986).

244. *Id.* at 1338.

245. *Id.*

246. *Id.* at 1338-40.

247. *Id.* at 1340.

248. *Id.* The court distinguished *K.M.C.* on the grounds that it involved a course of dealings covering a three-year period and involved a discretionary decision of whether to advance funds, not whether to call a loan. The court further stated that it found the *K.M.C.* court's application of U.C.C. § 1-208 to demand instruments "suspect" and, hence, refused to follow the holding. *Id.* at 1341.

249. *Id.* As authority for this proposition the court cited Linear Corp. v. Standard Hardware Co., 423 So. 2d 966, 968 (Fla. 1st D.C.A. 1982); Doral Country Club, Inc., v. Curcie Bros., Inc., 174 So. 2d 749 (3d D.C.A.), *cert. denied*, 180 So. 2d 656 (Fla. 1965).

250. The court cited to FLA. STAT. § 671.205(4) (1985).

> [4]The express terms of an agreement and an applicable course of dealing or usage of trade shall be construed wherever reasonable as consistent with each other; but when such construction is unreasonble express terms control both course of dealing and usage of trade and course of dealing controls usage of trade.

Therefore, the course of dealings did not override the lending limit set forth in the loan agreement and the loan could be called upon demand.[251]

U.C.C. § 1-208 specifically applies the good faith obligation to options to accelerate at will.[252] However, the official comment prevents this section from applying to demand instruments whose very nature allow a lender to call the note at any time without reason.[253] The official comment calls into question the *K.M.C.* court's sweeping application of the good faith obligation to demand instruments. Further, the court did not need to resort to good faith. The court could have reached a just result using the traditional contract theories of modification, waiver, or estoppel.[254] Applying good faith to demand notes means the note is not payable upon demand, but payable only when demand is made in good faith. This contradicts the specific financing agreement terms. Applying good faith to demand instruments contradicts the underlying purpose of good faith to protect the parties' expectations.[255] The practical result of holding good faith inapplicable to demand instruments is to simply make bad faith unavailable as a defense to a borrower subject to a lender's demand for payment under a demand note.

A lender may not take total refuge in a loan agreement's demand provision. The lender must still perform or enforce any right under the demand note in good faith.[256] In borderline cases, when loan agreements contain both a demand provision and a discretionary advance

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Id. Cf. Yankton Prod. Credit Ass'n v. Larsen, 219 Neb. 610, 615-16, 365 N.W.2d 430, 434 (1985) (court recognized that the obligation of good faith may override express loan provisions).

251. 485 So. 2d at 1340.

252. *See supra* note 200.

253. The official comment to U.C.C. § 1-208 (1978) states "[o]bviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without any reason. This section applies only to an agreement or to paper which in the first instance is payable at a future date." Courts take the view that demand instruments are payable immediately upon execution. Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 518 P.2d 734, *cert. denied*, 519 U.S. 967 (1974) ("It is elementary that a demand note is payable immediately on the date of its execution."). *Id.* at 536, 518 P.2d at 738.

254. Tyler, *supra*, note 1, at 418. In his article, Tyler criticizes the K.M.C. court's use of good faith and reasons that K.M.C. could have been decided easily under traditional contract principles. *Id.* at 418-19. Tyler suggests the court should have found the contract modified through subsequent conduct or oral agreements; or that the lender waived a contractual right or was estopped from exercising the contractual right. *Id.*

255. *See supra* note 194 and accompanying text.

256. Good faith will still apply to other provisions of the contract through the general good faith requirement imposed under U.C.C. § 1-203.

provision, liability may turn on the borrower's dependence on the lender and the extent of the lender's power to determine the fate of the borrower's business. In this situation, borrowers may resort to traditional contract theories for redress.[257]

B. *Course of Conduct Modifying Loan Agreement*

A lender's course of conduct may modify the loan agreement, thus preventing a lender from strictly enforcing the loan provisions.[258] Consequently, courts may require lenders to notify borrowers before any action is taken on a loan, despite an express loan provision stating no such notification is required.[259] Notification requirements typically arise when the parties establish a course of conduct varying from the express loan terms and the borrower relies on this conduct.[260]

A pattern of conduct may override express loan provisions through contract principles of modification and estoppel.[261] For example, in *Alaska Statebank v. Fairco*,[262] the Alaska Supreme Court affirmed an award against a lender who repossessed collateral without notice after negotiations failed to work out a deferred payment plan.[263] The court found the course of dealings and routine acceptance of late payments had modified the express loan provisions.[264] The lenders were estopped from repossessing the collateral without notice, even though the loan agreement permitted it.[265]

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257. *See supra* note 254.

258. *See* Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983); Varela v. Wells Fargo Bank, 15 Cal. App. 3d 741, 93 Cal. Rptr. 428 (1971); Ford Motor Credit Corp. v. Waters, 273 So. 2d 96 (Fla. 3d D.C.A. 1983); Nevada Nat'l Bank v. Huff, 94 Nev. 506, 582 P.2d 364 (1978); Fontaine v. Industrial Nat'l Bank of R.I., 111 R.I. 6, 298 A.2d 521 (1973).

259. Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983).

260. *See supra* note 258.

261. Ford Motor Credit Corp. v. Waters, 273 So. 2d 96 (Fla. 3d D.C.A. 1973); Cobb v. Midwest Recovery Bureau Co., 295 N.W.2d 232 (Minn. 1980); *see also supra* note 258.

262. 674 P.2d 288 (Alaska 1983).

263. *Id.* at 292-93.

264. *Id.* at 292 n.7. The court stated that although payments were due on the 10th of the month, the bank routinely allowed payments by the 30th of the month. "By its acts and statements, the Bank modified the terms of the note such that the $120,000 note had not been delinquent or in default by virtue of payments being made between the 10th and 30th of the month." *Id. Accord* Pierce v. Leasing Int'l, Inc., 142 Ga. App. 371, 372-73, 235 S.E.2d 752, 754 (1977); Cobb v. Midwest Recovery Bureau Co., 295 N.W.2d 232 (Minn. 1980); Nevada Nat'l Bank v. Huff, 94 Nev. 506, 513, 582 P.2d 364, 369 (1978).

265. 674 P.2d at 292. While acceptance of late payments may be found to modify a loan agreement, nonwaiver clauses have been upheld. Van Bibber v. Norris, 419 N.E.2d 115, 122 (Ind. 1981). *But see* Westinghouse Credit Corp. v. Shelton, 645 F.2d 869, 873-74 (10th Cir. 1981) (nonwaiver clause can be waived, and whether a waiver has occured is a jury question); Smith v. General Fin. Corp., 243 Ga. 500, 255 S.E.2d 14 (1979).

Courts have also invoked these contract principles to prevent a lender from accelerating upon transfer of the collateral to a third party. In *Warren v. Ford Motor Credit Co.*,[266] the court awarded punitive damages against a secured creditor who accepted loan payments from a third party in possession of the collateral.[267] The court estopped the lender from asserting the transfer of the collateral was a default.[268] By continuing to accept payments from the third parties, the lender had waived the default.[269] Thus, the court found the lender liable for conversion for repossessing the car when the loan was not in default.[270]

Courts are generally hostile toward nonmonetary default clauses permitting loans to be accelerated without showing the borrower's future ability to make loan payments is impaired. In *Brown v. Avemco Investment Corp.*,[271] a lender accelerated the loan because the borrower breached a "due on lease" clause.[272] The Ninth Circuit held that U.C.C. § 1-208 prevents a secured creditor from accelerating a loan unless the creditor believes in good faith that the breach impaired prospects for payment or performance.[273] The lender never asserted that loan payments were not being made or would not be made in the future.[274] Rather, the lender accelerated based on some uncertainty about the borrower's insurance and lack of lender approval for the collateral's lease.[275]

The court applied U.C.C. § 1-208, classifying the clause as discretionary and thus, analogous to insecurity clasues governed by U.C.C. § 1-208.[276] Hence, the good faith obligation qualified the lender's ability to call the loan under the clause which, under section 1-208, required the lender to be insecure regarding future payments.[277]

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266. 693 F.2d 1373 (11th Cir. 1982).
267. *Id.* at 1377-79.
268. *Id.* at 1376.
269. *Id.*
270. *Id.* at 1377.
271. 603 F.2d 1367 (9th Cir. 1979).
272. The clause provided that "if any or all of the property covered hereby be hereafter sold, leased, transferred, mortgaged, or otherwise encumbered without the written consent of Secured Party . . . then the whole principal sum unpaid upon said promissory note, with the interest accrued thereon . . . shall immediately become due." *Id.* at 1369.
273. *Id.* at 1376-77.
274. *Id.* at 1371.
275. *Id.*
276. *Id.* at 1378-79.
277. *Id.* at 1378.

Sahadi v. Continental Illinois National Bank & Trust Co.[278] also illustrates courts' suspicion of lenders who call a loan in default when they are not threatened monetarily. In *Sahadi*, the lender called the loan in default when the borrower failed to make a timely interest payment.[279] However, evidence revealed the borrower had sufficient deposits at the lender bank against which the lender could have set off payment.[280] Further, the lender did not show timely payments were particularly important.[281] The court reversed a summary judgment for the lender and remanded the case to determine whether the lender had acted in good faith.[282]

C. *The Future of Good Faith*

As the most open-ended liability theory, good faith is potentially the most threatening to lenders. Borrowers may assert breach of good faith when the lender's conduct falls short of fraud, duress, or interference.[283] Borrowers proceeding under this theory can perhaps attribute their phenomenal success to the ease with which jurors understand the theory, compounded by the dissatisfaction most jurors have experienced with banks.[284] Moreover, since courts broadly interpret the good faith obligation, borrowers may more easily assert liability for breach of this obligation and prevent reversal on appeal.[285] Consequently, this theory will only increase in popularity for asserting lender liability.

IV. SETTING LIMITS FOR LENDER LIABILITY

The past two decades have brought forth expanding liability among the professions. No logical explanation exists to shelter bankers from liability when medical, legal, and accounting professionals are held accountable for their misconduct. However, expanding liability, especially in the tort area, has been criticized as reaching a harmful level

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278. 706 F.2d 193 (7th Cir. 1983).

279. *Id.* at 194. There was further evidence that the lender had previously accepted late payments under a predecessor loan agreement. *Id.*

280. *Id.* at 196.

281. *Id.* at 197.

282. *Id.* at 200.

283. For example, a lender may be found liable for failure to give notice before declaring default. *See supra* note 259, at 292-93.

284. Swartz, *supra* note 2, at 16.

285. *See, e.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).

prompting legislative response.[286] For instance, the Florida Legislature enacted the Tort Reform and Insurance Act of 1986 as a comprehensive measure to address a general liability crisis.[287]

Lender liability also has the potential to reach harmful levels.[288] Because lender liability is a new area, its parameters are presently undefined. The increased publicity of multimillion dollar awards has led to a substantial increase in the number of lender liability claims.[289] Viewed optimistically, more responsible lender conduct should result. However, publicity also carries the potential for runaway juries and the assertion of spurious claims. The judiciary can begin shaping reasonable contours for lender liability. Consistently applying the liability theories coupled with treating lenders and borrowers equally will result in greater certainty in this area.[290] Prudent application should encourage a more efficient operation of the credit markets.[291]

Examining the role senior creditors play in the credit market will help delineate limits which should be placed on lender liability.[292] Recently, the benefits of a senior creditor's monitoring expertise have been recognized.[293] Senior creditors in protecting their own interests

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286. The expansion of liability has been blamed for the skyrocketing costs of insurance premiums. Staff of the Fla. Sen. Comm. on Commerce, FLORIDA MEDICAL MALPRACTICE REFORM AND A REVIEW OF COURT-ORDERED ARBITRATION, 30 (Jan. 1988).

287. *Id.* For a comprehensive review of Florida's Tort Reform Act, see *id.*

288. In fact, lender liability has been labeled the motor vehicle torts of the eighties. Swartz, *supra* note 2, at 19.

289. Moss, *supra* note 16, at 66; Swartz, *supra* note 2, at 19; Tyler, *supra*, note 1, at 441.

290. NCNB Nat'l Bank v. Tiller, 814 F.2d 931 (4th Cir. 1987).

291. The debtor-creditor relationship embraces a variety of risks which cannot be fully anticipated. With the addition of the uncertainty of lender liability, the difficulty of properly assessing credit risk increases. This results in a loss of efficiency through over or undercompensation of these credit risks. Increasing the certainty in this area will enable lenders to evaluate better the risks inherently brought forth with lender liability.

292. The potential for lender liability most often arises when a creditor has leverage against the debtor. With leverage comes the power to control the debtor. This is best exemplified by the position assumed by a senior secured creditor. Analyzing the role of a senior secured creditor will create a better understanding of the typical position a lender is in.

293. *See* Scott, *supra* note 21. In his article, Scott reviews the theories proposed to justify secured credit and the influential position enjoyed by the senior secured party. Initially, secured credit was justified on the premises that secured credit made credit available to high risk debtors who otherwise would not be able to obtain credit. *Id.* at 901-02. This theory, however, has been undermined with the development of modern finance theory. *Id.* at 902. The problem is that the benefits to secured creditors are offset by the increased costs to unsecured creditors who suffer from the reduction in assets available upon the debtor's default. *Id.* This has been labeled a zero sum game since the benefits to the secured creditor are achieved at the expense of the unsecured creditors. *Id.* (citing Schwartz, *Security Interests and Bankruptcy Priorities: A*

often provide sophisticated financial management otherwise unavailable to the debtors.[294] Further, by extensively monitoring the debtors, senior creditors generate external benefits recognized as a "public good."[295]

Most importantly, a senior creditor's broad based monitoring releases other creditors from the monitoring task, preventing a duplication of effort.[296] This reduces the more junior creditors' monitoring costs.[297] In essence, the junior creditors "free ride" on the senior creditor's monitoring expertise.[298] Hence, the senior creditor provides broad monitoring and input which are valuable services benefiting all participants with a stake in the debtor's enterprise.[299] Lender liability should not be expanded to deprive other creditors of this useful service.

The impending threat of the debtor's insolvency disrupts cooperation and increases tension.[300] In addition, the market and reputational constraints on the borrower break down, increasing the borrower's incentive to engage in high risk or wrongful conduct to salvage operations.[301] Typically, the senior creditor is encouraged to step in not only to help the debtor, but to provide valuable monitoring.[302] Everyone wins if the debtor's business is saved. If the senior creditor's efforts prove unsuccessful, junior creditors and the debtor view the senior creditor as the deep pocket against whom losses may be mitigated. In the scramble to salvage the debtor, distinguishing lender misconduct from legitimate efforts to protect the lender's interests becomes difficult. Realizing the benefits accruing from lender control will enable a more responsible judicial response to control abuses. The judiciary must develop workable guidelines so lenders are not discouraged from helping a debtor facing financial difficulties.

Review of Current Theories, 10 J. LEGAL STUD. 1, 10-11, 18-21 (1981)). Scott justifies secured credit through the monitoring expertise provided by the senior secured creditor. *Id.* at 902-03. *See also* Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982).

294. Scott, *supra* note 21, at 931.

295. *Id.*

296. *Id.*

297. *Id.* at 902, 931.

298. *Id.* at 902, 931-32; *see also* Levmore, *supra* note 21, at 53-54 (discussing the problems of free-riding).

299. Scott, *supra* note 21, at 931.

300. D. ROME, supra note 23, ¶ 8.01, at 8-2 to 8-3.

301. Scott, *supra* note 21, at 924. Scott points out that as long as business remains good, the need to maintain a market reputation and goodwill constrains a debtor's misconduct. However, as the debtor's business deteriorates, he has less to risk and more to gain from misconduct. *Id.*

302. *Id.* at 919-22.

Fairness mandates equal treatment of both the lender and borrower. A good faith obligation imposed on a lender should also be accompanied by a corresponding obligation on the borrower. For instance, courts often impose a good faith obligation requiring the lender to continue advancing funds until the borrower has the opportunity to seek alternative financing.[303] Such an incentive encourages the borrower to use these funds in a high risk fashion to save the failing business.[304] Thus, a corresponding obligation of good faith should be imposed on the borrower to deter misuse of those funds.[305]

Responsible judicial action enhanced by an awareness of how the credit market operates can help define the scope of lender liability. Senior creditor's valuable monitoring expertise should be preserved with the obligation of fair dealing imposed on both parties. Courts should balance the borrower's need for protection from arbitrary lender conduct against the creditor's need to take quick action upon default.[306] However, efforts to confine lender liability within reasonable bounds cannot rest solely with the judiciary. Lenders must also take action to establish respectable standards of conduct for their industry.

V. Impact of Liability on Lender Conduct

The doctrine of lender liability sends a signal to the banking industry that lending philosophies and practices must be altered. Lenders must sacrifice self-righteousness and arrogance if they want to control their destiny in the courtroom.[307] In surveying the cases in this area, a few guidelines can be set forth.

Most importantly, good faith should become a standard practice.[308] Borrowers should be treated reasonably and fairly.[309] Personality conflicts should be addressed immediately and lenders should always strive

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303. *See, e.g., supra* text accompanying notes 221-24.

304. Scott, *supra* note 293, at 919-22.

305. *See* Flick & Replansky, *supra* note 10, at 228 (authors point out that the *K.M.C.* court left open the question of whether a corresponding obligation of good faith would be imposed on the borrower).

306. A need for the creditor to act quickly is illustrated by a situation where a creditor holds a security interest in inventory and discovers the debtor is selling out of trust. A debtor sells out of trust when selling inventory without reinvesting the proceeds in other inventory or transferring the proceeds to the creditor as stipulated in the financing agreement. For a case in which the borrower's interests outweighed those of the lender's, see Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3d Cir. 1964).

307. Cappello, *Banking Malpractice?*, CASE & COM. Sept.-Oct. 1986, at 3, 6.

308. *Id.* at 7.

309. *Id.*

to conduct themselves in a professional manner.[310] While courts recognize a distinction between duress and a lender's hard negotiating position,[311] the lender should never imply a loan will be called if certain events occur, unless a lender has decided to take specific action.[312]

A full committee should review the decision to call a loan in default or terminate a credit line.[313] Although demand notes permit a lender to call the loan for any reason, lenders should nevertheless ensure legitimate business reasons exist which justify the calling.[314] Similarly, a lender should take care to justify exercising rights under a nonmonetary default clause. Lenders should not exercise these rights in an offensive manner. Generally, the lender must believe the borrower's ability to pay is impaired and substantiate this belief by showing a substantial change in the borrower's position.[315] If the default involves collateral and the loan appears fully secured, before repossessing, the lender must justify its belief the collateral is impaired.[316] The best preventative measure against liability is to notify the borrower before any action is taken on the loan.[317]

The loan agreement often plays a central role in determining liability.[318] Clauses conferring control to the lender should be avoided. For instance, a lender should not include clauses permitting it to make management decisions or control day-to-day operations.[319] If stock se-

310. Personality conflicts are especially dangerous when lenders face assertions of breach of good faith. *See* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 761 (6th Cir. 1985) ("[T]he jury may have concluded that [the lender] abused his discretion in refusing without notice to advance funds despite knowing he was fully secured because of his disapproval of [the debtor's] management philosophy."). Sahadi v. Continental Ill. Nat'l Bank & Trust Co., 706 F.2d 193 (7th Cir. 1983); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984).

311. *See* Continental Ill. Nat'l Bank & Trust Co. v. Stanley, 606 F. Supp. 558 (N.D. Ill. 1985).

312. Such a statement will be viewed by a court as a threat. *See* State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984). A threat need not be wrongful. In the ordinary course of business, a secured creditor may have grounds to threaten to foreclose upon a defaulting debtor. *Id.* at 685.

313. *See* Swartz, *supra* note 2, at 22.

314. *Cf.* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (applying the obligation of good faith to demand notes).

315. *See* Brown v. Avemco, 603 F.2d 1367 (9th Cir. 1979).

316. *See* Sahadi v. Continental Ill. Nat'l Bank & Trust Co., 706 F.2d 193 (7th Cir. 1983).

317. *See* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985); Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983); Cobb v. Midwest Recovery Bureau Co., 295 N.W.2d 232 (Minn. 1980).

318. *See, e.g.,* Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 689 (Tex. Ct. App. 1984).

319. Moss, *supra* note 16, at 72.

cures the loan, the agreement should provide that the lender receives no voting right until default.[320] To avoid liability under RICO, the lender should carefully draft the loan's interest rate, including a precise method of calculating the prime rate.[321] Further, the lender should make no oral representations concerning the enforcement of any provision.[322] Most important, the loan should correctly reflect the lender's regular practices and the parties' true understanding.[323]

While *Farah* infers that management clauses are impermissible,[324] authority suggests that properly drafted management clauses which balance the rights of both the lender and borrower are permissible.[325] However, because control liability may arise under such a clause, parties should carefully evaluate the use of these clauses.[326] The lender should include a management clause only if the lender feels it would not otherwise lend.[327] If the lender finds a management clause is necessary, the preferred individuals should be specifically named.[328] Finally, in exercising rights under a management clause, the lender may suggest several candidates, but should never choose the individuals.[329]

A lender should not excessively pressure the board of directors. The lender should not send a representative to board meetings, or participate in board member selection.[330] Interlocking directorships will give the appearance of impropriety and lenders should avoid them entirely.[331]

Further, lenders should be especially careful to maintain good files.[332] All employees should be informed that a jury may ultimately

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320. *See* Flick & Replansky, *supra* note 10, at 241. In the BUSINESS WORKOUTS MANUAL, Rome suggests that stock should not be taken as security since the creditor already has priority over shareholders as to access to corporate assets. D. ROME, *supra* note 23, ¶ 8.03[3][c], at 8-10.

321. *See* Flick & Replansky, *supra* note 10, at 225.

322. *See* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985). *See also supra* note 214 (parol evidence rule may bar statement made by bank representative where constitutional rights or fraud are not involved).

323. This will prevent liability where a course of conduct which varies from the express loan provision is found to have modified the loan agreement. Merely complying with the loan provisions will not prevent liability. *See* Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983).

324. *See supra* text accompanying notes 86-104.

325. Parsons Steel, Inc. v. First Ala. Bank, 679 F.2d 242 (11th Cir. 1982); *In re* Ludwig Honold Mfg. Co., 46 Bankr. 125 (Bankr. Pa. 1985).

326. *See* Flick & Replansky, *supra* note 10, at 236.

327. *Id.*

328. *See id.*; *see also* D. ROME, *supra* note 23, ¶ 8.03, at 8-12 to 8-13.

329. D. ROME, *supra* note 23, ¶ 8.03, at 8-12 to 8-13.

330. *Id.* at 8-10 to 8-11.

331. *See id.* at 8-11 to 8-12.

332. Cappello, *supra* note 307, at 7.

read any filed materials.[333] Lenders should maintain careful records of all defaults under a loan.[334] If a lender decides to take action on a default, it should be put in writing and become part of the borrower's file.[335] Finally, the lender should include complete records of all conversations with the borrower in the file.[336]

Overall, the lender must listen and be sensitive to the borrower's interests. When problems arise, the lender should make strong efforts to resolve them.[337] Both the lender and borrower have an interest in securing the borrower's business. In a workout, the borrower should be primarily responsible for structuring the plan.[338] Such responsibility ensures the borrower's management team is committed to and enthusiastic about the plan.[339] Since problems often arise due to tension between the lender and borrower, a free exchange of ideas will prove beneficial to all.

VI. CONCLUSION

The doctrine of lender liability is permeating the banking industry. Bankers must adapt their lending practices and become more sensitive to the borrower's interests or face the price of liability. The lender liability theories vary regarding the degree of control required to impose liability.[340] The historical development and consequences associated with the various lender liability theories justifies these varying standards.[341]

Liability for the mere potential to exercise control, however, runs contrary to the underlying rationale justifying control liability.[342] Courts generally impose control liability because exerting such control conveys some benefit to the dominant party.[343] Without the actual exercise of control, the dominant party receives no benefit justifying

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333. *Id.*

334. *See* Flick & Replansky, *supra* note 10, at 227.

335. *See id.* at 236.

336. Moss, *supra* note 16, at 72.

337. D. ROME, *supra* note 23, at ¶ 8.07.

338. *Id.* ¶ 9.01[4].

339. *See id.* For more information, refer to list of sources in Swartz, *supra* note 2, at 27. *See also* H. CHAITMAN, REPRESENTING THE LENDER IN LITIGATION (Practicing Law Inst. May-June 1986); Carter & Morgan, *Keeping Lenders From Breaking Boundaries That Lead to Liability*, 3 BANKR. STRATEGIST 3 (1986) (*cited in* Tyler, *supra* note 1, at 446 n.138)..

340. *See supra* text accompanying notes 35-36.

341. *See supra* text accompanying notes 129-86.

342. *See supra* text accompanying notes 63-67.

343. *See supra* text accompanying note 22.

liability. Hence, courts should not impose liability for unexercised loan provisions which only appear to confer control.

In applying the fiduciary obligation to the lender-borrower relationship, courts should employ a stringent standard commensurate with the harsh penalties accompanying such an obligation.[344] A standard requiring complete domination to the extent the borrower maintains no separate interests removes some practical problems inherent in imposing a fiduciary duty on a lender.[345]

The concepts of excessive control, duress, fraud, and good faith are well-suited to curb lender misconduct. Lenders, like other professionals, should be responsible for their misconduct. However, in applying these theories, courts should be aware of how the credit markets operate and recognize the valuable service senior creditor's monitoring expertise provides. Courts should not allow lender liability to reach a level where lenders are discouraged from helping a debtor in financial difficulties. However, in all transactions, lenders must make good faith a standard practice and encourage a free exchange of ideas. Everyone wins if a workout proves successful and the debtor again becomes profitable.

Melissa Cassedy

344. *See supra* text accompanying notes 152-66.
345. *See supra* text accompanying notes 160-65.