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LENDER LIABILITY IN MISSOURI: BITING THE HAND THAT FEEDS OR MERELY BITING BACK?

I. INTRODUCTION

A recent flood of lawsuits brought against financial lenders by borrowers is collectively known as lender liability lawsuits. These lawsuits have dramatically changed the banking industry and the fundamental relationship between lenders and borrowers. The figures awarded to plaintiffs against lenders have sent shockwaves throughout the banking industry. In 1987, juries returned seven of the top ten awards against lenders. Though plaintiff-borrowers did not fare as well in 1988, lender liability still poses a very real threat for the financial lending community.

A. Scope

Part II of this Article surveys the various common law (contract and tort) theories which plaintiffs have used against lending institutions. Part III examines the public policy considerations surrounding lender liability. Finally, Part IV of this Article suggests ways in which lending institutions might try to limit their liability exposure or otherwise protect themselves. This Article’s focus is the application of Missouri law to lender liability theories.

B. Overview

What is lender liability? Though the phrase “lender liability” is relatively new to legal jargon, this does not mean that courts are recognizing new causes of action. Instead, lender liability denotes the application of already recognized causes of action against lending institutions. One author suggests

3. Where no Missouri authority exists to support (or deny) a particular theory, leading cases from other jurisdictions are noted.
this definition: "Taken together, lender liability claims are simply those that arise from a financial relationship which is, or becomes, or is perceived to be, one in which economic leverage is too one-sided and may have been abused."\(^4\)

The practitioner should recognize the elements of lender liability theories from her first year law study. The law supporting lender liability has remained relatively constant. Only the facts, or more appropriately, the defendants, have changed. To the practitioner, this should be a relief, as case law abounds under the various theories. As an advocate, the practitioner's job will be to find the appropriate cause of action for her client's claim. Subsequently, the practitioner must tailor that cause of action to include those activities carried on by the lender.

How did the notion of borrowers suing lenders become so pervasive? Edwin A. McCabe offers an explanation in his excellent article entitled "What Rough Beast . . . ?":

How in the world did lenders get themselves into this much trouble? Little more than two decades ago, the courtroom view of the loan gone bad was quite different. Banks only went to court to collect. Debtors (a/k/a deadbeats) made noise, offered excuses, ranted and raved. But there were truly only two questions to be asked: Did you borrow the money? Did you pay it back? If the answers were "yes" and "no" respectively, the case was over. Promissory notes and personal guarantees were the stuff of summary judgment.

. . . .

. . . . the banking industry [went through a] . . . revolution in the 1970s . . . . The banker who had once been thought to be approachable only with hat in hand was suddenly advertising that he wanted to be considered a friend . . . . Quick approval. Instant credit. Write your own loan.

. . . . Thus was the lender liability stage set. Borrowers were encouraged to have high expectations. The public, and the businessman, responded. In a time of spiralling inflation, it made good sense to borrow today and to repay tomorrow in inflated dollars. And so they did. Lenders wanted their business, made money by "selling" credit, wanted to be thought of as friends. In such heady times, borrower and lender came naturally together, particularly on the farm where land values soared and supported heavy borrowing for equipment, and in the oil patch where only a fool didn't borrow to get in on a price-per-barrel headed for $60, or maybe even $100.

. . . . When the crunch came, borrowers looked to their lenders to be friends, to be the "partners in progress" they had once seemingly asked to be. What they encountered instead were workouts, and too little sympathy and understanding, and sometimes simply panic. Bankers wanted to revert to their more traditional role and to limit their courtroom experience to the asking of the two questions: Did you borrow the money? Did you repay it? Instead, they found themselves deep-pocket defendants, and their borrowers represented by skillful trial lawyers working on con-

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tingent fees, ready to portray the lender not as the lofty source of financing for America's businesses but as greedy and unprincipled. It was a whole new game.5

C. Theories Commonly Asserted

Plaintiffs have used a variety of legal theories, with varying degrees of success, in pursuing causes of action against lending institutions. The common law theories include both contract and tort actions. The contract theories include: (1) breach of oral or written commitment to lend; (2) breach of the duty of good faith and fair dealing; and (3) waiver/estoppel.

The following tort theories have also been advanced: (1) fraudulent misrepresentation (2) constructive fraud (also known as negligent misrepresentation) (3) economic duress (4) tortious interference with contract (5) intentional infliction of emotional harm (6) defamation (7) prima facia tort (8) breach of fiduciary duty (9) negligence, and (10) tortious breach of the duty of good faith and fair dealing. In addition, plaintiffs have also relied on various state and federal statutes in an attempt to hold the creditor liable.6

D. The Role of the Lender

In order to understand the public policy arguments surrounding lender liability, it is essential to understand the role of the lender in the financial

5. McCabe, supra note 1. See also Bock, You're Foreclosing? I'm Suing!; Borrowers Are Fighting Bankers Who Use Heavy-Handed Tactics, TIME, May 9, 1988, at 68. The author notes: While the increase in lawsuits can be attributed in part to growing litigiousness, some bankers have themselves to blame. In the early 1980’s, lenders aggressively sought new borrowers in farming and oil, pushing generous loans under the presumption that the good times would keep on rolling. But when the bottom fell out of petroleum and commodity prices, many ventures were unable to meet payments. In some cases panicky bank officers intervened too harshly, giving borrowers grounds to sue.

Id.

6. While important, the various statutory theories advanced by plaintiffs are beyond the scope of this Article. Situations in which lenders are being held liable when they foreclose on real property that subsequently turns out to contain hazardous waste are of growing importance. For example, in United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986), the court held that a foreclosing lender could be held liable as an owner for hazardous waste site cleanup. For a discussion of the steps lenders should take to protect themselves from exposure to environmental cleanup costs, see Mott, Minimizing Environmental Liability for Lenders: The Most Common Mistakes, 51 Banking Rep. (BNA) 949 (Dec. 5, 1988); see also Gillon, Lender Liability Under CERCLA: The Impact of Fleet Factors, 52 Banking Rep. (BNA) 698 (Mar. 20, 1989) (suggesting that “secured creditors should avoid exerting any more control over the borrower, financial or otherwise, than is necessary to preserve their security interests” to avoid being held liable for hazardous waste cleanup).
marketplace. Of course, the role of the lender differs depending on an individual's perspective. To the attorney vigorously defending the lender, the lender is a good samaritan extending financial assistance to another friend in need. To the plaintiff's attorney seeking a huge jury verdict, the lender is a greedmonger, or perhaps worse—the Benedict Arnold who betrays the borrower when things get rough. In most instances, neither of these two portrayals is accurate. The following explanation of the role of the lender provides a starting point:

In economic terms, the lender is a middleman. The lender facilitates the workings of the market for capital by matching sellers of the use of capital, investors, with buyers of the use of capital, businessmen [borrowers]. For its service of matching buyers and sellers of capital, the lender receives a part of the price paid for its use.7

In reality, lending is nothing more, nor less, than a business for profit. In attempting to make a profit, the lender must meet the needs of its customer, the borrower. Those lenders that the public perceives as serving their needs best are the same lenders that attract new customers, grow, and turn a bigger profit. Like any business, lenders must make tough decisions. These decisions typically involve denying credit or foreclosing when the borrower defaults. No one suggests that the law should hold lenders responsible for all economic failures. However, lender liability advocates suggest that lenders, like other businesses, should operate under similar standards of good faith and reasonableness.

II. LEGAL THEORIES

A. Various Contract Theories

1. Breach of Written and Oral Commitments to Lend

Lenders and borrowers typically reduce loan negotiations into a set of writings which become the basis of a loan agreement. In the context of lender liability cases, generally two issues arise. First, did the parties intend to enter into a loan agreement or were the writings exchanged between them mere invitations to enter negotiations? Second, if the parties intended to form a contractual relationship, is the contract, as written, sufficiently definite to be enforceable?8 The following cases demonstrate ways borrowers

8. This issue also arises when the borrower alleges that the lender modified the original loan agreement. This dispute generally occurs after the lender has extended credit a number of times and the parties are negotiating over another extension. The borrower typically alleges that the lender, by either his words or actions, has modified the due date by granting another extension. Bahls, Termination of Credit for the Farm or Ranch: Theories of Lender Liability, 48 MONT. L. REV. 213, 220-21 (1986).
have sought to hold lenders liable for breaching written commitments to lend.

In Sterling Faucet Co. v. First Municipal Leasing Corp., the Eighth Circuit Court of Appeals upheld a district court’s finding that a letter “announce[d] the commitment of funds by First Municipal Leasing Corporation . . . for the leasing of certain equipment” and was a binding contract to lend money. The lender argued that the letter was a mere invitation to negotiate a loan agreement. However, the letter contained clear language, the name of the parties, the terms of the loan (including the amount), and the conditions precedent. The district court therefore found the letter constituted a valid agreement to loan money.

In 999 v. C.I.T. Corp., the Ninth Circuit Court of Appeals upheld a judgment for the borrower who alleged breach of an agreement to provide financing. The borrower, a Nevada corporation, was in the process of acquiring a financially troubled Missouri corporation, Bee Cee. The borrower entered into negotiations with the lender to obtain approximately six million dollars in financing. The lender presented a handwritten letter to the president of the borrower. The letter requested the borrower to make a deposit of $25,000 and to submit an application for financing. At the request of the borrower, the lender outlined the terms of the proposed financing agreement. The borrower then signed the letter. Subsequently, the lender attempted to add a $25,000 per month prepayment penalty as a condition to the financing. The borrower demanded the lender drop the condition, but the lender refused. The borrower obtained substitute financing and the resulting delay allowed Bee Cee’s unsecured creditors to force the corporation into involuntary bankruptcy.

The borrower brought suit, charging that the breach of the financing commitment had caused it to lose the opportunity to acquire Bee Cee.

9. 716 F.2d 543 (8th Cir. 1983), aff’d, No. LR-C-80-276 (E.D. Ark. 1982).
10. Id. at 543-44.
11. Id.
12. Id. The district court determined that the borrower, Sterling Faucet, had fulfilled the conditions precedent. Id.
13. Id.
14. 776 F.2d 866 (9th Cir. 1985).
15. Id. at 867.
16. Id. at 867-68.
17. Id. at 868. The borrower planned to invest $300,000 in the Missouri corporation. Id.
18. Id.
19. Id.
20. Id.
21. Id.
22. Id.
23. Id.
24. Id.
Unfortunately, the issue of whether such a letter formed a contract remains unresolved. During pre-trial discovery, the defendant admitted that the letter comprised an agreement. At trial, the jury awarded the borrower $1.9 million which the court remitted to $925,000. On appeal, the lender charged that the trial court abused its discretion when it denied the lender’s motion to withdraw the admission. The appeals court affirmed the trial court’s decision.

As both Sterling Faucett and 999 indicate, courts are willing to find contractual relationships between borrower and lender, so long as the agreement outlines the material terms with some degree of specificity. This judicial interpretation indicates that lenders may not want to reduce the negotiations into writing unless it is willing to extend credit. Similarly, if the lender is not ready to extend credit, it should only reduce the “negotiations” into writing if it clearly indicates that the writing is not an offer to lend. The writing should be only a mere representation of the negotiation of the terms under which it will consider lending. It should also clearly specify those terms to which the parties have not yet agreed. Bank counsel should review all such letters.

In addition to breach of written commitments to lend, plaintiffs have also sought to enforce oral commitments to lend. Like cases brought under written commitments to lend, the issue usually is whether the terms agreed upon, albeit verbally, are definite enough to enforce the contract.

For example, in Labor Discount Center, Inc. v. State Bank & Trust Co., the plaintiff brought an action against six banks alleging that the banks breached an oral agreement to provide interim financing. The trial court held that the plaintiff failed to prove an enforceable contract for lack of sufficiently definite terms. The Missouri Court of Appeals affirmed the summary judgment, saying:

There was not . . . any evidence as to due date, security, rate of interest, time for payment, etc. Taken alone, the absence of any one of these terms might not be of great significance; viewed collectively, however, their

25. Id.
26. Id. The jury returned the $1.9 million on two separate verdicts, one for breach of contract and one for negligent misrepresentation. However, the court allowed the borrower to accept only one verdict. When the lender moved for a new trial, the court conditioned denial of a new trial on acceptance of the remittitur by the borrower. Id.
27. Id.
28. Id. at 873.
30. Id.
32. Id. at 418.
33. Id. at 419-20.
absence is fatal and the alleged promise was correctly found by the trial court to be too indefinite to admit of enforcement.\textsuperscript{34}

In \textit{Dennis Chapman Toyota, Inc. v. Belle State Bank},\textsuperscript{35} another Missouri case, a car dealership brought an action against a lender alleging breach of an oral contract to lend money. The bank argued that any "alleged contracts" to lend should have been in writing.\textsuperscript{36} The Missouri Court of Appeals said, "[W]e have the tentative opinion that a valid cause of action for breach of an oral contract to lend money is recognized at law.\textsuperscript{37}" The court then turned its attention to whether the contract was definite enough to enforce.\textsuperscript{38} After citing a variety of cases which held contracts were held unenforceable for lack of definiteness,\textsuperscript{39} the court held that the oral contract sued upon was too indefinite to enforce.\textsuperscript{40}

Plaintiffs do occasionally win, and win big, under this cause of action. For example, in \textit{Landes Construction Co. v. Royal Bank},\textsuperscript{41} the Ninth Circuit Court of Appeals upheld an $18.5 million jury verdict based on the lender's breach of an oral agreement to lend. Nevertheless, absent lending documentation, borrowers face a difficult task of proving the parties agreed to all of the material terms.

\textsuperscript{34} Id. at 425. It is interesting to note an additional argument raised by defendants in \textit{Labor Discount}. The defendants asserted that there could be no oral agreement to extend additional financing because federal and state-mandated limits prohibited them from making additional loans that would exceed the loan limits. \textit{Id.} at 422. The banks asserted that these federal and state statutes served as an absolute defense. \textit{Id.} The appellate court said: "It is our view that the statutes are for the regulation of banking institutions and the officers thereof and not for the frustration of well-meaning though unwary borrowers." \textit{Id.} Nevertheless, the appellate court noted that since such an additional loan would exceed the federal and state loan limits, this provided at least some evidence that the loan officer had not extended such an offer. \textit{Id.}

35. 759 S.W.2d 330 (Mo. Ct. App. 1988).
36. \textit{Id.} at 334.
37. \textit{Id.} (citing \textit{Wait v. First Midwest Bank-Danville}, 142 Ill. App. 3d 703, 707, 491 N.E.2d 795, 800 (1986)).
38. \textit{Id.}
39. \textit{McErlean v. Union Nat’l Bank of Chicago}, 90 Ill. App. 3d 1141, 414 N.E.2d 128 (1980) (borrower brought action against commercial lender for breach of oral and written contract to extend line of credit; appeals court affirmed trial court’s dismissal of the case, finding that the contract was too indefinite); \textit{Labor Discount Center, Inc. v. State Bank & Trust Co.}, 526 S.W.2d 407 (Mo. Ct. App. 1975) (oral agreement to furnish interim financing to complete construction of discount store too indefinite to be enforced); \textit{Malaker Corp. v. First Jersey Nat’l Bank}, 163 N.J. Super. 463, 395 A.2d 222 (1978), \textit{certification denied}, 79 N.J. 488, 401 A.2d 243 (1979) (bank’s alleged oral agreement to make an unrestricted line of credit available to plaintiff was unenforceable as a matter of law because its terms were not specifically described).
40. \textit{Dennis Chapman Toyota}, 759 S.W.2d at 336. The court noted the following terms were not established: (1) interest rate; (2) terms of repayment; and (3) duration of line of credit. \textit{Id.}
41. 833 F.2d 1365 (9th Cir. 1987).
2. Good Faith and Fair Dealing

Every contract carries an implicit duty to act in good faith and deal fairly with each party. In *Martin v. Prier Brass Manufacturing Co.*, a Missouri court noted this duty, saying:

> It is a fundamental principle and concomitant of agreements that: ‘Every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement.’ That duty prevents one party to the contract to exercise a judgment conferred by the express terms of agreement in such a manner as to evade the spirit of the transaction or as to deny the other party the expected benefit of the contract.

Missouri Revised Statutes Section 400.1-203 provides: “Every contract or duty within this chapter imposes an obligation of good faith in its performance or enforcement.” Section 400.1-201(19) defines good faith to be “honesty in fact in the conduct or transaction concerned.” Where the defendant is a merchant, Section 400.2-103(1)(b) provides that good faith “means honesty in fact and the observance of reasonable commercial standards of fair dealing in trade.”

*K.M.C. Co. v. Irving Trust Co.*, represents the leading breach of duty case in the lender liability area. The jury awarded plaintiff $7.5 million for the bank’s failure to make further advances under a discretionary line of credit. The plaintiff asserted that this refusal constituted bad faith. The Sixth Circuit adjudged the lender’s action by the objective standard of whether a reasonable loan officer, with a fully secured loan, would have refused to advance funds to the borrower without notice. Finding

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43. 710 S.W.2d 466 (Mo. Ct. App. 1986).
44. *Id.* at 473 (citing RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981)) (emphasis added).
48. 757 F.2d 752 (6th Cir. 1985).
49. *Id.* at 754-55.
50. *Id.* at 760-61. The court noted: [T]o a certain extent the conduct of [the lender] must be measured by objective standards. While it is not necessary that [the loan officer] have been correct in his understanding of the facts and circumstances pertinent to his discussion not to advance funds for this court to find that he made a valid business judgment in doing so, there must at least some objective basis upon which a reasonable loan officer in the exercise of his discretion would have acted in that manner.

*Id.* at 761 (emphasis in original).

In Rigby Corp. v. Boatmen’s Bank & Trust Co., 713 S.W.2d 517, 533 (Mo. Ct. App. 1986), the court seemed to hold a holder of a note to a subjective
that ample evidence existed for the jury to determine that no reasonable loan officer, in the same situation, would have refused to advance funds, the appeals court upheld the jury's verdict.\textsuperscript{51}

Courts have been unwilling to find a lender liable for breaching its duty of good faith when the lender calls the pure demand loan. For example, in \textit{Centerre Bank v. Distributors, Inc.},\textsuperscript{52} the Court held that U.C.C. Section 1-203, setting forth the good faith standard, was not applicable because "[t]he parties by the demand note did not agree that payment would be made only when demand was made in good faith but agreed that payment would be made whenever demand was made."\textsuperscript{53} The Court would not rewrite the agreement to add this additional term of "good faith."\textsuperscript{54}

In \textit{Shaughnessy v. Mark Twain State Bank},\textsuperscript{55} a Missouri appellate court held that the lender breached its duty of good faith in declining to advance funds under an irrevocable line of credit.\textsuperscript{56} The plaintiff, a real estate developer, sued his lender alleging breach of contract and prima facia tort.\textsuperscript{57}

standard of good faith, saying:

In terms of insecurity . . . a creditor acts in good faith who acts on what he believes he knows, whether or not what he believes is actual. It is enough that the creditor honestly believes that the payment of the debt is impaired to act with good faith in the call for more collateral . . . .

To act with \textit{honesty in fact} in the call for more collateral, and hence in good faith under § 400.1-208, however, is to act without caprice or arbitrary purpose. That is to say, the belief of insecurity which prompts the call for more collateral may not be bereft of rational basis nor amount to an open abuse of that discretionary power.

\textit{Id.} at 533 (citing \textit{K.M.C. Co.}, 757 F.2d at 761). The \textit{Rigby} court suggested that the standard of good faith under section 400.1-208, which allows a secured creditor to demand additional credit "only if he in good faith believes that the prospect of payment or performance is impaired," is less stringent and more subjective than the commercial reasonableness and fair dealing requirement under Article 2 of the Uniform Commercial Code as it applies to merchants. \textit{Id.} at 533.

51. \textit{K.M.C. Co.}, 757 F.2d at 766.

52. 705 S.W.2d 42 (Mo. Ct. App. 1985).

53. \textit{Id.} at 48.

54. \textit{Id.} Note that the comment to section 1-208 of the U.C.C. supports the Court's holding. It provides, in part: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason. This section applies only to an agreement or to paper which in the first instance is payable at a future date." U.C.C. § 1-208 comment (1989).

55. 715 S.W.2d 944 (Mo. Ct. App. 1986).

56. \textit{Id.} at 954.

57. \textit{Id.} at 946. As to the prima facia tort claim, the appellate court affirmed the trial court's ruling that the plaintiff had failed to show an intent to injure, and thus upheld the directed verdict on this issue. \textit{Id.} at 948-49.
The lender contended there was no substantial evidence that it had breached a contract. Specifically, the lender argued that it cannot be liable for breaching a contract to lend when the loan is payable on demand. The lender also asserted that if there was a good faith duty to disburse the funds, the plaintiff failed to make a submissible case on the issue.

The court initially determined that the loan instrument was not a demand note, but rather a line of credit. It then focused its attention to whether the defendant enjoyed a right to refuse disbursement. Citing K.M.C. Co., the court noted that an implied duty to act in good faith may exist under a line of credit contract.

The Shaughnessy court acknowledged that in Centerre the Western District of Missouri had declined to impose a good faith obligation when a bank calls a demand note. The court reasoned that calling a demand note is a “more onerous burden on the debtor than when a bank refuses to disburse additional funds.” As a result no duty of good faith appeared to exist in the context of a line of credit. In addition, the court distinguished Centerre from K.M.C. Co.. In K.M.C Co., the lender had required the borrower to deposit all of his receipts into a “blocked account.” When the lender refused to advance funds, this in effect left the borrower without any operating capital unless he could have secured alternative financing. In Shaughnessy, the lender had not required the borrower to deposit all of his funds with the lender, thus distinguishing the present case from K.M.C. Co.

Despite being able to distinguish its case from K.M.C. Co. and the more onerous nature of calling a debtor’s demand note, the Shaughnessy court turned its attention to the question of whether the line of credit was irrevocable. The Shaughnessy court acknowledged several definitions of

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58. Id. at 950.
59. Id. at 949-50.
60. Id. at 950.
61. Id. at 951. The court said that “a demand note, on issue, . . . is due” and noted that the contract made several references to a maturity or due date in the future. Id. In addition, the court noted that the parties agreed in an extension of the loan to modify it so that it became due in the future and that this modification agreement did not mention the word “demand.” Id. at 952.
62. Id. at 952. The document was silent as to the terms of the line of credit, including whether the lender enjoyed a right to refuse disbursement. Id. at 953.
63. Id. at 953.
64. Id. (citing Centerre, 705 S.W.2d at 48).
65. Id.
66. Id.
67. Id.
68. Id.
69. Id. In other words, was there a commitment to loan a certain amount? Because the contract was silent as to this issue, the court had to look to definitions and other factors. Id. at 954 n.9.
line of credit made by other courts, but acquiesced to the following:

Line of credit signifies a limit of credit extended by bank to its customer, *to the full extent of which the customer may avail itself* in its dealing with the bank, but which the customer may not exceed. It most frequently covers a series of transactions, in which case, when the customer's line of credit is nearly exhausted or not replenished, the customer is expected to reduce its indebtedness by payments to the bank before making additional use thereof.\(^7\)

A line of credit "contemplates irrevocability because its speaks of a limit 'to the full extent of which the customer may avail itself.'"\(^7\) The court held that the lender had entered into a commitment which established an irrevocable line of credit for the borrower.\(^7\) Thus, the lender was obligated to fund the borrower, unless the borrower defaulted.\(^7\) The court added:

[Y]our holding does not mean that banks will be compelled to throw good money after bad. If the debtor defaults, the relationship can be ended. Nor does this mean the bank will be forced to make the all or nothing decision of lending or foreclosing if the borrower is defaulting. So long as there is a default, the lender can make the note due and payable and then extend payments .... Indeed, a bank can expressly inform its borrower that the arrangement is revocable or irrevocable.\(^7\)

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70. *Id.* at 953. For example, in Midatlantic National Bank v. Commonwealth Gen. Ltd., 386 So. 2d 31, 33 (Fla. Dist. Ct. App. 1980), the court said:

A line of credit is a limit of credit to cover a series of transactions .... It does not impart upon the bank the legal responsibility to loan up to the limit or a responsibility of the lender to borrow up to the limit, but merely facilitates the easier extension of credit. Accordingly, if information later comes to light which reflects upon the borrower's ability to satisfy his debts, a bank need not fund the entire line of credit.


72. *Id.* (quoting *Modoc*, 271 Or. at 284, 532 P.2d at 25).

73. *Id.* The court also noted that the lender had charged the borrower a one percent commitment fee when it established the loan agreement and that the agreement contained an expiration date. *Id.*

74. *Id.*

75. *Id.*; see also Commercial Cotton, Inc. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985); Weinberg v. Farmers State Bank, 752 P.2d 719 (Mont. 1988). See generally *Comment*, supra note 42, at 1186, wherein the author noted the problem unique to line of credit loans:

The line of credit is a transaction of convenience. The lender preapproves the borrower for a certain number of dollars in credit, and gives him an account, or line, upon which he can draw. The borrower then takes advantage of an expedited process for getting a loan, submitting a request for an advance on the line rather than a new loan application. The lender normally requires the borrower to submit periodic financial reports in order to monitor the borrower's financial condition. However, this arrangement presents a difficult situation when a financially troubled borrower begins to depend on advances from the credit line. The borrower's only
What lessons can lenders learn from *K.M.C. Co.* and *Shaughnessy*? First, the lender should clearly specify that a loan instrument is payable on demand, and not a line of credit.\(^76\) Second, if the loan is a line of credit, there may exist a duty to act in good faith in administering the funds. This especially holds true when refusal to disburse funds devoids the borrower of operating capital.\(^77\) The lender may have to provide adequate notice to the borrower before refusing to advance funds so the borrower may secure alternative financing.\(^78\) Third, barring default or fear of losing its security interest in the collateral, the lender should continue extending line of credit payments until the borrower reaches the designated level.\(^79\)

3. Waiver and Estoppel

Practically speaking, lenders often accept late payments from borrowers for various reasons. Borrowers subsequently charge that the lender’s consistent acceptance of late payment lull them into a false sense of security. When the borrower can demonstrate consistently accepted late payments, some courts will find that the lender waives the right to insist upon timely payments in the future.\(^80\) The lender’s decision to refuse late payments should be provided in written notice to the borrower.\(^81\)

Courts have also applied the equitable theory of estoppel\(^82\) to prevent lenders from exercising their contractual rights to accelerate loan payments.

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\(^76\) 715 S.W.2d at 952. The factors the *Shaughnessy* court noted in finding that the loan instrument was not a demand note included: (1) language specifying that the interest rate changes after the note becomes “due and payable;” (2) the instrument listed eight events constituting default, the happening of which causes the obligation to become due and payable regardless of the *maturity date* (the court noting that a demand instrument is due when issued); (3) borrower’s agreement that failure to pay at maturity constituted default; and (4) that the promissory note was extended through modification, and nowhere in the modification were the words “on demand” to be found. *Id.*

\(^77\) *K.M.C. Co.*, 757 F.2d at 759.

\(^78\) *Id.*

\(^79\) *Id.*


\(^81\) Bahls, *supra* note 8, at 222.

\(^82\) The elements of promissory estoppel are: (1) a promise; (2) on which the plaintiff relies to his detriment; and (3) wherein the injustice can be avoided only by enforcement of the promise. Mark Twain Plaza Bank v. Lowell H. Listrom & Co., 714 S.W.2d 859, 863 (Mo. Ct. App. 1986).
The Supreme Court of Oklahoma in *Knittel v. Security State Bank*\(^{83}\) held that a statement made by the lender's officer, assuring the debtor that the lender would not consider a late payment a default, precluded the lender from accelerating the loan based on the default.\(^{84}\)

**B. Various Tort Theories**

Plaintiffs generally try to recover against lenders under tort theories, rather than under contract theories. One reason is that the contract itself often limits recovery. For example, the contract might provide for liquidated damages, beyond which the plaintiff is unable to recover. A plaintiff's recovery in an action sounding in tort is not limited to contractual constraints. A plaintiff may also sue under a tort theory to recover damages that she would be unable to recover under contract law. Under contract law, damages put the plaintiff in the position she would have been in had the breach not occurred.\(^{85}\) Under tort theory, damages compensate the plaintiff for injuries "proximately caused."\(^{86}\) Perhaps the most important reason plaintiffs prefer the tort approach is to recover punitive damages.\(^{87}\) Punitive damages punish bad behavior and seek to deter similar conduct in the future.\(^{88}\) Thus, if a plaintiff recovers punitive damages, in essence he is recovering damages not directly attributable to his losses. Some detractors characterize punitive damages as a windfall for the plaintiff. Nevertheless, under current tort law, when the defendant's conduct allows it,\(^{89}\) the law allows the plaintiff to recover punitive damages.

One author suggests that tort actions are not appropriate in commercial loan cases, but may be appropriate for breaches of consumer loan contracts:

> Where the relationship between the parties is commercial in nature, recovery for economic loss should be limited to contract. . . . In the commercial setting, losses suffered because of negligent breach of contract, including consequential damages, are insurable. Moreover, where the parties are customarily of comparatively equal bargaining power, contract law provides sufficient protection. This is not necessarily true in a consumer situation. First, consumers typically cannot insure themselves against losses that might result from negligence. . . . Second, the parties do not have equal bargaining power. A consumer applicant is given few rights of negotiation with the lender. For this reason, the consumer's recourse should not be limited to the agreement between the parties.\(^{90}\)

\(^{83}\) *593 P.2d 92, 95 (Okla. 1979).*

\(^{84}\) *Id.* at 96.


\(^{87}\) *Id.* § 2, at 11-15.

\(^{88}\) *Id.* § 2, at 9.

\(^{89}\) *Id.* § 2, at 14.

The following text surveys the application of various tort theories in lender liability cases. The reader should ask whether limiting recovery to contractual remedies would have been appropriate, or whether there is a need for tort recovery. In the following cases, focus upon the role of the lender and the relative bargaining strength between the lender and borrower.

1. Fraudulent Misrepresentation

The tort theory most often alleged against lenders is fraudulent misrepresentation. In Missouri, the elements of fraudulent misrepresentation include: (1) a false, material misrepresentation; (2) the speaker's knowledge of its falsity or his ignorance of its truth; (3) the speaker's intent that the hearer act upon the misrepresentation in a manner reasonably contemplated; (4) the hearer's ignorance of the falsity of the statement; the hearer's reliance on its truth, and the right to rely thereon; and (6) proximate injury.91

A case illustrative of the issues present under a fraudulent misrepresentation theory is Kruse v. Bank of America.92 In Kruse, the California Court of Appeals reversed a jury's verdict for $47 million dollars in both compensatory and punitive damages.93 In Kruse, an individual (Kruse) filed suit against apple growers and a bank alleging that the lender fraudulently induced her into transferring her stock in the apple processor based on the promise of long-term financing.94 The apple growers (Jewells) filed cross-complaints against the bank, basically claiming three things: (i) the bank had fraudulently failed to disclose certain information and in doing so, wrongfully induced the Jewells to borrow beyond their means; (ii) once hopelessly overextended, the bank reneged on its promise to provide long-term financing, and (iii) that the bank failed to apply sale proceeds to debts owed to other creditors as it had promised to do.95 The court first addressed the Jewells' complaint.

91. Gast v. Ebert, 739 S.W.2d 545 (Mo. 1987) (en banc) (action to rescind a release agreement with defendant's insurer). The RESTATEMENT (SECOND) OF TORTS § 526 (1977) sets forth the following elements for fraudulent misrepresentation: (1) misrepresentation of fact, opinion, intention, or law; (2) made when the maker knows it is false or does not have confidence in its accuracy; (3) for the purpose of inducing another to act or to refrain from action in reliance upon it; (4) who justifiably relies on the misrepresentation and is thereby damaged.


93. Id. at ___, 248 Cal. Rptr. at 235. After a three-month trial, the jury returned a verdict against the lender, awarding $20,020,000 in compensatory damages and $27,675,000 in punitive damages. The trial court granted the lender's motion for a new trial conditioned on plaintiff's and cross-complainant's acceptance of a remittitur to $6 million in punitive damages. Id. at ___, 248 Cal. Rptr. at 219.

94. Id. at ___, 248 Cal. Rptr. at 231.

95. Id. at ___, 248 Cal. Rptr. at 230.
First, the Jewells alleged that the bank "fraudulently induced them to undertake the short-term borrowing without disclosing the possibility that their request for long-term financing would be denied."96 As to this claim, the court held that the record failed to establish justifiable reliance.97

As to the Jewells' claim that the bank failed to apply sale proceeds as promised, the court held that the plaintiffs had not proved causation. The court said:

Even if Bunch's, the local branch manager, promise [was] false and fraudulent, the property loss sustained by the Jewells was not the product of Bunch's false promise but was the direct result of their self-created indebtedness. Put differently, even had they not assigned the trust deeds, their property would still have been subject to the satisfaction of the existing claims of their creditors.98

The court then addressed the Kruse complaint. Mrs. Kruse alleged that the bank misrepresented to her that long-term financing would be forthcoming, and in doing so fraudulently induced her to transfer her controlling stock interest in a corporation to the Jewell family.99 After transferring her controlling stock, Mrs. Kruse was unable to obtain a long-term loan from another lender.100 The court noted that this "argument fails under its own weight, the record reflecting an absence of any substantial evidence supporting either an implied promise to lend money or the essential requirement of justifiable reliance."101

a. Misrepresentation of Intention to Renew Note or Extend Additional Credit

In Sanchez-Corea v. Bank of America,102 the Supreme Court of California upheld an award of one million dollars in compensatory damages and one million dollars in punitive damages against a commercial lender. The punitive damages award was based in part on a claim that the lender misrepresented its intent to extend long-term financing.103 The court noted: "[A]lthough the [B]ank had determined not to extend further loans to Cormac, the loan officers indicated that future financing might be forthcoming only after the assignment. One day after the accounts receivable ... were assigned to the Bank, the long term loan application was turned

96. Id. at ____, 248 Cal. Rptr. at 226.
97. Id. at ____, 248 Cal. Rptr. at 226.
98. Id. at ____, 248 Cal. Rptr. at 230.
99. Id. at ____, 248 Cal. Rptr. at 231.
100. Id. at ____, 248 Cal. Rptr. at 231.
101. Id. at ____, 248 Cal. Rptr. at 232.
103. Id. at 892, 701 P.2d at 826, 215 Cal. Rptr. at 682.
down."104 Finding that the evidence supported the verdict, the court upheld the jury’s determination.105

In *Stirling v. Chemical Bank*,106 the Second Circuit Court of Appeals held that a cause of action for fraud existed where a bank failed to fulfill its promise not to call outstanding loans. The court also relied upon the bank’s failure to make additional loans to plaintiff in return for the resignation of certain corporate officers and directors of the plaintiff.107 The *Sanchez-Corea* and *Stirling* cases serve as a warning to lenders to not make promises that they do not intend to keep.

Despite the above cases, where the loan agreement provides that the decision whether to extend additional credit is within the lender’s sole discretion, fraudulent misrepresentation is harder to prove. For example, in *In re Belco, Inc.*,108 the borrowers asserted that the lender had fraudulently misrepresented its intent to lend.109 The borrowers insisted they had dismissed a pending Chapter 11 action and sold certain interests in order to pay the proceeds to the bank. These actions were in reliance on the bank’s representation that it would extend a line of credit.110 The bankruptcy court held that the failure to extend a line of credit did not constitute actionable fraud since the agreement provided that the lender had total discretion as to whether it would make additional loans.111 The *Belco* court’s implicit rationale was that the bank’s discretionary lending clause in the loan agreement prevented the borrowers from claiming reliance, a material element of fraudulent misrepresentation. Though such language would provide some evidence of reliance, it should not be dispositive—certainly the lender may have made oral representations to the borrower following the execution of the loan agreement upon which the borrowers might have relied.

b. Misrepresentation for Failure to Disclose Material Information to Borrower

*Centre Bank of Kansas City v. Distributors, Inc.*,112 represents the most significant lender liability case in Missouri. Guarantors of a note alleged that the lender had fraudulently misrepresented the classification of the loan by failing to disclose that the lender had classified the note as a problem loan.113 The Missouri Court of Appeals for the Western

104. *Id.* at 909, 701 P.2d at 838, 215 Cal. Rptr. at 691.
105. *Id.* at 892, 701 P.2d at 826, 215 Cal. Rptr. at 691.
107. *Id.* at 1158.
109. *Id.* at 528-29.
110. *Id.*
111. *Id.*
112. 705 S.W.2d 42 (Mo. Ct. App. 1985).
113. *Id.* at 52-53.
District held that no confidential or fiduciary relationship exists, between a bank and its customer who borrows funds, for fraudulent nondisclosure.\textsuperscript{114} Similarly, the court reasoned that no confidential or fiduciary relationship exists between the bank and the guarantors of a note. The defendant bank, thus, was under no duty to disclose to the guarantors of a note that their note was classified as a problem note.\textsuperscript{115} The \textit{Centerre} court placed a great amount of emphasis on the fact that the guarantor had managed the debtor business prior to its agreement to act as guarantor.\textsuperscript{116} The court reasoned that the guarantor could not have looked to the bank for information on the business’ financial well-being and thus the bank did not owe him a fiduciary duty.\textsuperscript{117}

As the \textit{Centerre} case demonstrates, a lender generally does not have an affirmative duty to disclose material information to a borrower. Nevertheless, parties sometimes have an “obligation to speak rather than remain silent, when a failure to speak is the equivalent of fraudulent concealment.”\textsuperscript{118} This obligation arises “where one person is in position to have and to exercise influence over another who reposes confidence in him whether a fiduciary relationship in the strict sense of the term exists between them or not.”\textsuperscript{119}

In \textit{Barnett Bank v. Hooper},\textsuperscript{120} the borrower borrowed funds to invest with an investment company after a bank officer assured the borrower that the investment company was financially sound and had passed IRS scrutiny.\textsuperscript{121} Despite this representation, the bank, in reality, was suspicious that the investment company was involved in a check kiting scheme.\textsuperscript{122} The court held that in this instance the bank owed its customer a duty to disclose and had breached this duty.\textsuperscript{123} The court noted:

[W]here a bank becomes involved in a transaction with a customer with whom it has established a relationship of trust and confidence, and it is a transaction from which the bank is likely to benefit at the customer’s expense, the bank may be found to have assumed a duty to disclose facts material to the transaction, peculiarly within its knowledge, and not otherwise available to the customer.\textsuperscript{124}

\textsuperscript{114} \textit{Id. at 53.}
\textsuperscript{115} \textit{Id.}
\textsuperscript{116} \textit{Id.}
\textsuperscript{117} \textit{Id.}
\textsuperscript{118} \textit{Union Nat’l Bank v. Farmers Bank, 786 F.2d 881, 887 (8th Cir. 1986).}
\textsuperscript{119} \textit{Id. (quoting Hanson Motor Co. v. Young, 223 Ark. 191, 265 S.W.2d 501 (1954)).}
\textsuperscript{120} \textit{498 So. 2d 923 (Fla. 1986).}
\textsuperscript{121} \textit{Id. at 924.}
\textsuperscript{122} \textit{Id.}
\textsuperscript{123} \textit{Id. at 925-26.}
\textsuperscript{124} \textit{Id. at 925. See also First Nat’l Bank v. Brown, 181 N.W.2d 178 (Iowa 1970); Denison State Bank v. Madera, 230 Kan. 684, 640 P.2d 1235 (1982); Richfield Bank & Trust Co. v. Sjogren, 309 Minn. 362, 244 N.W.2d 648 (1976); Deist v. Wachholz, 208 Mont. 207, 678 P.2d 188 (1984).}
1. Constructive Fraud

Actual fraud exists where the plaintiff can prove that the defendant knew his representations were false and intended to defraud the plaintiff. In the absence of such intent or knowledge, plaintiffs claim that the lender’s representations were negligently made and constituted constructive fraud. In order for constructive fraud to exist, a special relationship must exist between the parties so that one relies, to its detriment, on the other. In *White v. Mulvania*, a Missouri court said: “If . . . a confidential relationship can be proved at trial, proof of actual fraud is unnecessary. It is well established that the breach of a promise made during such a relationship will be considered constructively fraudulent because of the special reliance present.”

Constructive fraud is sometimes known as negligent misrepresentation. Section 552 of the Restatement (Second) of Torts provides that negligent misrepresentation occurs when “[o]ne who, in the course of his business, profession, or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions . . . fails to exercise reasonable care or competence in obtaining or communicating the information.” One found liable for negligent misrepresentation “[i]s subject to liability for pecuniary

125. In *Union National Bank v. Farmers Bank*, 786 F.2d 881, 886 (8th Cir. 1986) (quoting Miskimins v. City Nat’l Bank, 248 Ark. 1194, 1204, 456 S.W.2d 673, 679 (1970) (citations omitted)), the court noted that “[c]onstructive fraud arises from ‘a breach of a legal or equitable duty, which the law declares to be fraudulent because of its tendency to deceive others, regardless of the moral guilt, purpose or intent of the fraudfeasor.’”

126. 575 S.W.2d 184 (Mo. 1978) (en banc) (holding that testatrix had a right to rely on counsel-executor’s alleged promise).

127. *Id.* at 189.

128. *RESTATMENT (SECOND) OF TORTS* § 552 (1976). Illustration 11 in comment h sets forth the following example:

A Bank receives an inquiry from B Bank respecting the credit-worthiness of C Corporation, a customer of A Bank. B Bank informs A Bank that the reason for the inquiry is that D & Co., an advertising agency, has been approached by C Corporation with a request that it manage a $200,000 advertising campaign for C Corporation on the local television station; that under the terms of its customary arrangement with the television station, D & Co. would be guarantor of any amount owing the station, and that D & Co. has requested its bank to ascertain from C Corporation’s bank whether C Corporation is sufficiently credit-worthy to incur and satisfy a liability of $200,000. A Bank, without checking C Corporation’s account, and without a disclaimer of liability for its answer, replies that it believes C Corporation to be good for such an obligation. D & Co. arranges for the advertising campaign and shortly thereafter C Corporation enters bankruptcy. A Bank is subject to liability for negligence to D & Co.
loss caused to them by their justifiable reliance upon the information." 129 This theory is used both by borrowers alleging that lenders misled them into borrowing and by lenders alleging that other lenders misled them into loaning money.

For example, in Hill v. Equitable Bank, 130 a group of investors brought suit against a bank alleging that the bank had negligently misrepresented the soundness of an investment scheme. Relying on Jacques v. First National Bank, 131 the court concluded that the bank owed the plaintiff a duty of care and denied summary judgment on the negligent misrepresentation claim. 132

In Union National Bank v. Farmers Bank, 133 a bank which purchased a note claimed that another bank had committed constructive fraud by failing to warn of a note maker's financial strength. 134 The court held that constructive fraud was not applicable, because the plaintiff's reliance was not justifiable. 135 The court noted that the plaintiff's officers were knowledgeable and experienced in purchasing such notes, but failed to seek out available information as to the maker's financial strength. 136

The Supreme Court of Mississippi, in Berkline Corp. v. Bank of Mississippi, 137 held that a lender may incur liability where one of its bank officers makes representations or omissions of material facts concerning credit worthiness of one of its customers. 138 The court held that even when the lender offers such information gratuitously, the lender must "use the

129. Id.
132. Id. at 650-51. After discussing the public policy rationales (i.e., the nature of the banking industry and its relation to public welfare), the court said: This policy rationale is equally appropriate to finding a duty against negligent misrepresentation under the facts of this case. Plaintiffs solicited Rous' [defendant's agent] view of the Eagle investment, as well as financing from the bank. Rous suggested that plaintiffs deposit money at the bank while representing that plaintiffs would receive loans and that the investment was sound. Whether or not he should have told plaintiffs more about the bank's relationship to Eagle is a jury question. Based on the meeting and the resulting deposits, a contractual relationship came to exist which required the bank to exercise due care in communicating facts to plaintiffs. Id.; see also Danca v. Taunton Sav. Bank, 385 Mass. 1, 429 N.E.2d 1129 (1982); Banker's Trust Co. v. Steenburn, 95 Misc. 2d 967, 409 N.Y.S.2d 51 (N.Y. Sup. Ct. 1978).
134. 786 F.2d at 886.
135. Id. at 887.
136. Id.
137. 453 So. 2d 699 (Miss. 1984).
138. Id. at 702.
skill and expertise which they hold themselves out to the public as possessing."

In Central States Stamping Co. v. Terminal Equipment Co., the lender was liable for failing to disclose that another defendant, Terminal Equipment Company, had defaulted on two previous loans with it. The plaintiff, Central States Stamping Co., was considering advancing Terminal Equipment $50,000 to build a piece of machinery for the plaintiff. Before advancing such, plaintiff called Terminal Equipment’s bank and inquired about the financial strength of Terminal Equipment. Mr. Martin, the bank’s officer, failed to disclose that Terminal Equipment was financially unstable and was in default on two loans. The court said:

"[O]nce Martin undertook to advise [plaintiff] with respect to Terminal's financial condition he had a duty to disclose information in his possession which would reasonably be considered material to the decision he knew [plaintiff] was in the process of making. Martin knew that [plaintiff] had confidence in his knowledge about Terminal. His positive answers were likely to induce [plaintiff] to accept Terminal’s proposal. Failure to disclose Terminal’s true financial position made his previous positive responses misleading at least."

Once a lender takes on the responsibility of providing information courts are sometimes willing to find that a duty exists to use due care in providing such information. This duty does not arise simply because someone inquires about this information. Instead, whether a duty arises is based on the particular facts of the case.

In Vacinek v. First National Bank, private lenders brought suit against a bank alleging that it had intentionally misrepresented debtor’s financial status. The court held that the bank had no duty to disclose a mortgage on debtor’s property to private lenders who were considering making a loan. The court also noted that a fiduciary relationship did not exist between the bank and the private lenders. Despite the long standing relationships between the private lenders and customers, the evidence failed to show that the bank had superior knowledge unavailable to the private lenders. Nor did the evidence illustrate that the bank knew the private lenders were placing their trust and confidence in them. Thus, the most

139. Id.
140. 727 F.2d 1405 (6th Cir. 1984).
141. Id. at 1409.
142. Id. at 1406-07.
143. Id.
144. Id.
145. Id. at 1409.
146. 416 N.W.2d 795 (Minn. Ct. App. 1987).
147. Id. at 797.
148. Id. at 799. The court noted that the private lenders never expressed their specific intent to loan the debtor money. Id.
149. Id. at 799-80.
important fact in determining whether a duty is owed to someone inquiring about the borrower’s financial stability is the amount of trust the inquiring party places in the lender.

If the inquiring party is especially skilled in these matters, and the information is available through other sources, a bank probably will not be liable for misrepresentation. The court’s holding in Vacinek demonstrates the fact that the lender must owe a duty to the plaintiff before the courts will hold the lender liable for either fraudulent or negligent misrepresentation.150

2. Economic Duress

Under the theory of economic duress, plaintiffs are required to prove the following elements: (1) a threat to do some act which the threatening party has no legal right to do; (2) some illegal exaction, fraud, or deception; (3) a restraint that is imminent and destroys free agency without present means of protection; and (4) the threatening party is responsible for the claimant’s financial distress.151

The leading economic duress case is State National Bank v. Farah Manufacturing Co.152 In Farah, the bank warned the corporate shareholders that it would consider the election of Farah to the board of directors as a default.153 Since the contract itself provided for acceleration upon default,154 the bank’s warning amounted to a threat of accelerating the loan if the corporate shareholders chose Farah instead of the person it had designated for the position.

The corporation sued the lender alleging that the lender had committed economic duress.155 The jury awarded the plaintiff $18.9 million.156 The Texas Court of Appeals upheld the jury verdict,157 finding that the lender’s

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150. No such duty exists in Missouri based solely on the relationship between lender and borrower. The lender-borrower relationship is characterized as creditor-debtor and is not a fiduciary relationship. Centerre Bank v. Distributors, Inc., 705 S.W.2d 42, 53 (Mo. Ct. App. 1985). Only where there is a confidential or fiduciary relationship between borrower and lender will the court impose on the latter a duty to disclose material facts. Id.

151. First Texas Sav. Ass’n v. Dicker Center, Inc., 631 S.W.2d 179, 185-86 (Tex. Ct. App. 1982); see also Pecos Constr. Co. v. Mortgage Inv. Co., 80 N.M. 680, 459 P.2d 842 (1969) (threat by mortgage lender not to provide financing together with its refusal to release its financing commitment to another lender unless borrower agreed to pay settlement costs of $12,000, even though no actual dispute existed, constituted duress amounting to business or economic compulsion).


153. Id. at 672.

154. Id. at 673.

155. Id. at 683.

156. Id. at 667.

157. Id. at 699. The court actually reformed the verdict, granting remittitur of $300,000, which reduced the award to $18.6 million. Id.
improper threat to exercise a default provision, when it had no intention of doing so, was actionable duress.¹⁵⁸ "Acceleration clauses are not to be used offensively such as for the commercial advantage of the creditor. They do not permit acceleration when the facts make its use unjust or oppressive."¹⁵⁹

The *Farah* court based its holding in part on section 1.208 of the Texas Business and Commerce Code. The *Farah* court concluded that section 1.208 provides that the lender’s proposal to accelerate must stem "[f]rom a reasonable good faith belief that its security was about to be impaired."¹⁶⁰ Finding that the lender did not believe that its security was impaired, the court found that the lender had committed actionable fraud.¹⁶¹

Although the *Farah* decision shocked the banking industry, its implications are not without limits. It is important to learn from the *Farah* decision the lengths to which courts will allow lenders to go in exercising control over their debtors. First, lenders should never threaten to take any adverse action as a means to coerce certain action by the borrowers. For example, banks should never threaten to accelerate existing loans if a farmer plants beans instead of corn. Similarly, a lender should not threaten acceleration to coerce the appointment of one of the bank’s officers to the borrower’s board of directors. Nevertheless, the bank may lawfully accelerate a loan when: (1) it is specifically permitted in the contract;¹⁶² or, (2) the bank’s security interest in the collateral securing the loan is jeopardized.¹⁶³ A lender’s acceleration of a debtor’s loan for reasons other than those stated above runs the risk of being held liable for fraud under the *Farah* rationale. Certainly, the lender should not make acceleration contingent upon certain actions. The courts would treat this as a threat under the *Farah* standard.¹⁶⁴

3. Tortious Interference with Contract

Plaintiffs often allege that, by failing to extend credit or by cutting off a line of credit, the lender has tortiously interfered with the borrower’s right to contract with a third party. The typical case arises when the borrower agrees to purchase machinery or other assets, after assurances

¹⁵⁸. *Id.* at 686.
¹⁵⁹. *Id.* at 685.
¹⁶⁰. *Id.* (emphasis added).
¹⁶¹. *Id.* at 688.
¹⁶². *Id.* at 684-86. Despite the holding in *Farah*, it would appear that where the contract specifically provides for acceleration, the lender may do so without risk. For criticism of the *Farah* rationale, see Bahls, *supra* note 8, at 240-41 and Note, *supra* note 7, at 732-37.
¹⁶³. 678 S.W.2d at 684-85.
from the bank that it will lend the necessary capital, only to find that the lender is unwilling to lend. Sometimes this mistaken belief is based in part on the lender's previous actions. The borrower often sues the lender for tortious interference with the borrower's contractual relationship. This interference results in the borrower's loss of business opportunity. Under certain circumstances, courts have held a lender liable for tortious interference, even where the contractual relation is merely prospective.\footnote{165} Even though there are no reported Missouri cases, Missouri does recognize this cause of action.\footnote{166} The most troublesome element for borrowers to prove is that the lender intended to cause the breach of contract.\footnote{167}

In most lender liability cases, defendants will raise the defense that it was either protecting or pursuing a legitimate business interest. For example, in \textit{Del State Bank v. Salmon}\footnote{168} the court held that a lender was not liable for tortious interference with contract when it intentionally interfered with the employment contract of a corporate president. The lender's means were fair and accompanied by an honest intent to better its own financial position.\footnote{169}

\footnote{165} Peterson v. First Nat'l Bank, 392 N.W.2d 158, 165-66 (Iowa Ct. App. 1986).

\footnote{166} See Tri-Continental Leasing Co. v. Arthur F.G. Neidhardt, 540 S.W.2d 210, 212 (Mo. Ct. App. 1976). Section 23.11 of the Missouri Approved instruction provides:

\begin{quote}
Your verdict must be for plaintiff if you believe:
First, a contract existed between plaintiff and (third party) which was [breached] [terminated] by [third party], and
Second, defendant caused [third party] to [breach] [terminate] his contract with plaintiff, and
Third, defendant did so intentionally and without justification or excuse, and
Fourth, plaintiff was thereby damaged.
\end{quote}


The Notes on Use point out that "[t]he term 'third party' means the one with whom plaintiff had a contract and the one who, at defendant's request, breached or terminated the contract." \textit{Id.}

\footnote{167} In Francisco v. Kansas City Star Co., 629 S.W.2d 524 (Mo. Ct. App. 1981), plaintiffs claimed tortious interference with contract. The Missouri Court of Appeals held that the trial court erred in denying the defendant's motion for a mistrial because the plaintiff failed to show that the defendant's actions were done with an intent to cause a breach of contract or done without justification. \textit{Id.} at 535; \textit{see also} Dobbs, \textit{Tortious Interference with Contractual Relationships}, 34 \textit{Ark. L. Rev.} 335 (1981).

\footnote{168} 548 P.2d 1024 (Okla. 1976).

\footnote{169} \textit{Id.} at 1027. The court said:
Evidence was sufficient to sustain a finding the bank's acts were designed to benefit the bank. Those acts could be found to be strong, aggressive, and intentionally made to protect the bank. Its economic power was used to influence Amerand's board to terminate Salmon's employment. The bank's primary object was to better its financial position as to the Amerand
In Jack L. Inselman & Co. v. FNB Financial Co., the buyer of fabric brought a tortious interference suit against a lender who had a factoring agreement with the seller. The borrower alleged that, by declining to extend further credit, the lender tortiously interfered with the contractual relationship between buyer and seller. The court noted that the lender had no obligation to extend further credit and that the lender was justified in demanding payments on the outstanding invoices before extending further credit.

4. Intentional Infliction of Emotional Harm

The intentional infliction of emotional harm is becoming a much more prevalent cause of action in lender liability suits. The elements for this cause of action are: (1) extreme and outrageous conduct; (2) done intentionally or recklessly, with knowledge or deliberate disregard that emotional distress will follow; (3) which causes severe emotional distress.

In Sanchez-Corea v. Bank of America, plaintiffs claimed that actions by the bank’s employees were designed to inflict emotional distress. The court found there was substantial evidence to support the jury’s verdict, and upheld the emotional distress claim.

loans. The primary object was not to wrongfully harm Salmon, though the acts were to his detriment. One need not agree with the bank’s actions, but it exercised a privilege to lawfully interfere.

Id.


171. Id. at 1080, 364 N.E.2d at 1120, 396 N.Y.S.2d at 348. The factoring agreement provided that the lender would guarantee the payment of accounts receivable owed by purchasers whom it deemed credit-worthy. Id. at 1079, 364 N.E.2d at 1119, 396 N.Y.S.2d at 348.

172. Id. at 1080, 364 N.E.2d at 1120, 396 N.Y.S.2d at 348.

173. Id. at 1080, 364 N.E.2d at 1120, 396 N.Y.S.2d at 348-49. The court held that the seller did not breach its contract with the buyer, thus the buyer could not maintain a tortious interference claim against the lender. Id. at 1080, 364 N.E.2d at 1120, 396 N.Y.S.2d at 349.


176. Id. at 897, 701 P.2d at 829-30, 215 Cal. Rptr. at 682.

177. Id. at 908, 701 P.2d at 837, 215 Cal. Rptr. at 690-91. The court noted: [T]here was extensive testimony about an incident at the San Francisco Hotel in San Francisco. According to the testimony, Bank officials publicly ridiculed [the plaintiffs], using profanity in their statements. A friend who was with the [plaintiffs] testified that Bank employees were . . . laughing about the financial plight of Cormac. In response to all these instances, [the plaintiffs] testified as to resulting problems of alcoholism, severe headaches, insomnia, tension and anxiety.

Id. at 909, 701 P.2d at 838, 215 Cal. Rptr. at 691.
In *Morse v. Mutual Federal Savings & Loan Association*, the mortgage lender’s wrongful acts [wrongful advertisement] in attempting foreclosure was a willful misuse of its power of sale. The court further viewed these wrongful acts as humiliating and distressful to the borrowers. The mortgage lender’s action, therefore, allowed recovery for "mental damages," which included mental suffering, defamation, and loss of reputation.

The Missouri Court of Appeals, in *Medlock v. Farmers State Bank*, held that a borrower/wife was not entitled to recover for emotional distress resulting from the bank’s failure to obtain credit life insurance on the borrower/husband. The court did not find a sufficient showing of malice, willfulness, wantonness or inhuman behavior.

5. Defamation

Defamation is one lender liability theory which has great ramifications for the smallest of lenders and those who sell consumer goods on credit. In *Alaska Statebank v. Fairco*, a bank’s wrongful repossession of collateral effectively "publicized" a false statement that the borrower had unjustifiably failed to pay its debts. The Supreme Court of Alaska construed this publication as defamatory in nature. "Statebank’s act of closing Clown-town (the plaintiff’s business which served as collateral for the loan) was suggestive of Fairco’s failure to honor financial obligations, constituting a (statement) that spread throughout the business community and impaired [plaintiff’s] relationship with customers, clients, employees, business associates and suppliers."

In *Reese v. First Missouri Bank & Trust*, the Supreme Court of Missouri held that no cause of action exists for attempted wrongful foreclosure. The mortgagors had brought suit seeking, among other things, recovery for damages done to their reputations. Finding that no cause of action existed for attempted wrongful foreclosure, the court declined to address a defamation cause of action. Thus, a Missouri plaintiff must

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179. *Id*. at 1280.
180. *Id*.
182. *Id*. at 879. The plaintiff alleged that she should recover emotional damages from an attempted wrongful foreclosure. *Id*. at 876. The Missouri Supreme Court has since held that no cause of action exists for wrongful foreclosure. See *Reese v. First Mo. Bank & Trust*, 736 S.W.2d 371, 375 (Mo. Ct. App. 1987) (en banc).
184. *Id*. at 294-95.
185. *Id*. at 295.
186. 736 S.W.2d 371 (Mo. 1987) (en banc).
187. *Id*. at 373.
188. *Id*. at 372.
189. *Id*. at 373.
establish the lender's actions as wrongful for reasons other than an attempted wrongful foreclosure in order to prevail under a defamation theory in lender liability.

6. Prima Facia Tort

A "prima facia tort" is a wrong that is not covered by a traditional tort liability. For example, in Boatmen's Bank v. Berwald,190 the bank brought an action to recover on a promissory note and the makers counterclaimed for prima facia tort. The court listed the following elements of prima facia tort: (1) an intentional lawful act of the defendant; (2) done with an intent to cause injury to the plaintiff; (3) which causes injury to the plaintiff; and (4) an absence of any justification (or an insufficient justification) for defendant's act.191 Thus, a prima facia tort exists where the act itself is legal, but the intent is to injure. The Berwald court held that the borrowers had not made out a cause of action for prima facia tort. The borrowers failed to establish that the bank had an intent to injure.192 Like other lender liability tort theories, the lender's intent to injure is the most difficult obstacle to overcome.

7. Breach of Fiduciary Duty

The relationship between lender and borrower is generally that of creditor-debtor.193 Absent any special relationship, the parties do not owe the other any sort of fiduciary duty.194 A plaintiff-borrower must show that some sort of special relationship existed in order to prevail under a breach of fiduciary duty theory. Creativity is needed and discovery will be of the utmost importance if the plaintiff is to prevail under this cause of action. In the following cases, courts have addressed the type of relationships that give rise to a fiduciary duty.

In Pigg v. Robertson,195 the borrower, Mr. Pigg, went to his bank to borrow money to buy a farm.196 The usual loan officer was not there, but the secretary told him he could talk to Mr. Robertson, the defendant.197 Mr. Pigg, believing Mr. Robertson to be a loan officer, told Mr. Robertson

190. 752 S.W.2d 829 (Mo. Ct. App. 1988).
191. Id. at 833 (citing Porter v. Crawford & Co., 611 S.W.2d 265, 268 (Mo. Ct. App. 1980)).
192. Id. at 834. See generally Missouri Court Overturns $150,000 Prima Facie Tort Lender Liability Jury Verdict, 50 Banking Rep. (BNA) 756 (May 2, 1988).
196. Id. at 598.
197. Id.
of his intent to buy the farm.\textsuperscript{198} When Mr. Pigg attempted to buy the farm, he learned that the defendant had already purchased it.\textsuperscript{199} The defendant was not an employee of the bank, but rather a vice-president of an investment company.\textsuperscript{200} The plaintiff brought suit, contending that Robertson's presence in the bank placed him in a position of trust. Robertson, therefore, was under a duty to divulge any material information and should not personally profit from information gained during the conversation.\textsuperscript{201} The defendant claimed that he had already learned of the farm and was interested in purchasing it prior to his conversation with Mr. Pigg.\textsuperscript{202}

The court held that although the relationship between bank and depositor is generally creditor-debtor, the relation may give rise to some particular obligation\textsuperscript{203}. These obligations included the duty not to disclose matters relating to customer's business without his consent and the duty to disclose to the depositor any material information concerning the conversation.\textsuperscript{204} The court found sufficient evidence to establish a confidential relationship and that Mr. Robertson had a duty to disclose his interest in the farm to Mr. Pigg.\textsuperscript{205}

In \textit{Production Credit Association v. Croft},\textsuperscript{206} the lender brought suit against the borrowers to foreclose on real estate mortgages and security agreements. The borrowers counterclaimed, alleging negligence,\textsuperscript{207} breach of fiduciary duty, and failure to disclose. Concerning the breach of fiduciary relationship, the Wisconsin court noted that two types of fiduciary relationships generally exist: "(1) those specifically created by contract or a formal legal relationship . . . and (2) those implied in law due to the factual situation surrounding the transactions and relationships of the parties

\textsuperscript{198} \textit{Id}. at 599.
\textsuperscript{199} \textit{Id}. The defendant sold the farm seven months later for a $45,000 profit.
\textit{Id}.
\textsuperscript{200} \textit{Id}.
\textsuperscript{201} \textit{Id}.
\textsuperscript{202} \textit{Id}.
\textsuperscript{203} \textit{Id}.
\textsuperscript{204} \textit{Id}. at 600 (citations omitted).
\textsuperscript{205} \textit{Id}. at 601. The court noted:
[Respondent acknowledged that, during [the bank president's] absence, bank employees asked him questions posed to them by customers and relayed respondent's replies to customers. Thus, respondent was aware that he was being called upon to provide advice for customers and a jury would have been entitled to find that a bank customer approaching respondent, under the circumstances in which appellant did so, had a right to expect that his disclosures would be given the same protection they would have received had they been made to a regular bank officer . . . .

\textit{Id}.
\textsuperscript{206} 423 N.W.2d 544 (Wis. Ct. App. 1988).
\textsuperscript{207} See \textit{infra} notes 251-53 and accompanying text.
to each other and to the questioned transactions.\textsuperscript{208} As to the former, the court further explained:

Lenders, under certain circumstances, require borrowers to comply with loan covenants restricting the operation of the borrower's business \ldots. These covenants often include promises to \ldots obtain lender approval of certain transactions. These covenants may serve to keep a "lease" on the operations of the borrower. Arrangements such as these should not give rise to the creation of a fiduciary duty so long as the lender's restraints are reasonably necessary to protect its interest in the collateral and are made in good faith.\textsuperscript{209}

The court reasoned that the loan provisions in question were to protect the lender's security interest and did not breach a fiduciary relationship created by the contract.\textsuperscript{210}

The court next inquired into whether the facts surrounding the loan gave rise to a fiduciary relationship. The court noted:

A fiduciary relationship between a lender and borrower may be established when a borrower demonstrates that a lender acted as financial advisor to a subservient borrower and the borrower relied on the lender's advice. Factors a court considers when determining whether borrowers are subservient generally include the borrower's age, mental capacity, health, education and degree of business experience. The courts also focus on the degree to which the subservient party entrusted his or her affairs to the lender and reposed confidence in the lender.\textsuperscript{211}

The lender's financial advice and encouragement in \textit{Production Credit} did not give rise to a fiduciary relationship between it and the borrowers.\textsuperscript{212}

8. Negligent Processing of Loan Renewal Application

In \textit{Jacques v. First National Bank},\textsuperscript{213} a Maryland court held that a bank which agreed to process a loan application owed the customer a duty of reasonable care in the processing and determination of that application.\textsuperscript{214} The borrowers in \textit{Jacques} entered into a contract to purchase a home for $142,000.\textsuperscript{215} The borrowers submitted a loan application and a $144 fee

\begin{itemize}
\item \textsuperscript{208} \textit{Production Credit}, 423 N.W.2d at 546 (citing Denison State Bank v. Madeira, 230 Kan. 684, 691, 640 P.2d 1235, 1241 (1982)).
\item \textsuperscript{209} \textit{Id.} at 546-47 (citing Bahls, \textit{supra} note 8, at 233).
\item \textsuperscript{210} \textit{Id.}
\item \textsuperscript{211} \textit{Id.} at 547 (citing Bahls, \textit{supra} note 8, at 231-32).
\item \textsuperscript{212} \textit{Id.} at 548; see also Mantooth v. Federal Land Bank, 528 N.E.2d 1132 (Ind. Ct. App. 1988); Shiple v. First Sec. Bank of Livingston, Inc., 762 P.2d 242 (Mont. 1988); Citizens State Bank v. Hahn, 146 Wis. 2d 865, 431 N.W.2d 327 (Ct. App. 1988) (not published in official reports).
\item \textsuperscript{213} 307 Md. 527, 515 A.2d 756 (1986).
\item \textsuperscript{214} \textit{Id.} at 540-45, 515 A.2d at 762-65.
\item \textsuperscript{215} \textit{Id.} at 528, 515 A.2d at 756. The contract provided for a down payment of $30,000 and was contingent upon obtaining financing for the balance ($112,000) at a rate of no more than 12 1/4% interest. \textit{Id.} at 528-29, 515 A.2d at 756-57.
\end{itemize}
to cover the costs of the appraisal and credit report.\textsuperscript{216} The interest rate offered by the lender at the time of the application was 11-7/8 percent.\textsuperscript{217} After processing, a loan officer informed the borrowers that they qualified for a loan of $74,000.\textsuperscript{218} The lender later informed the borrowers that it had erred, and that under the lender’s guidelines, the borrowers qualified for no more than $41,400.\textsuperscript{219}

The borrowers immediately began to look for additional financing.\textsuperscript{220} Because interest rates had risen, the most competitive rate available was 13-7/8 percent on $100,000 for thirty years from a competing lender.\textsuperscript{221} The borrowers determined that the loan at 13-7/8 percent would cost them an additional $50,000 over the life of the loan. The borrower subsequently accepted the loan of $41,400 from the defendant at 11-7/8 percent and secured an additional loan from the defendant of $50,000 at 15 percent interest rate to cover the rest of the purchase price.\textsuperscript{222}

The borrowers later filed suit, alleging malicious interference with contract, gross negligence, and negligence.\textsuperscript{223} The jury found the lender not liable on the malicious interference and gross negligence counts, but awarded the borrowers $10,000 compensatory damages on the negligence count.\textsuperscript{224} The Court of Special Appeals held that the lender owed no duty to the borrowers to use due care in processing the loan application.\textsuperscript{225} The Court of Appeals reversed, holding that a mortgage lender has a duty to exercise reasonable care in processing a loan application and in determining loan eligibility.\textsuperscript{226}

The court first determined that the borrowers could have properly asserted a claim for breach of contract because the mortgage loan application did create a contract.\textsuperscript{227} The court then said, “implicit in the undertaking

\textsuperscript{216} Id. at 529, 515 A.2d at 757.
\textsuperscript{217} Id.
\textsuperscript{218} Id. at 530, 515 A.2d at 757.
\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} Id.
\textsuperscript{222} Id. To secure this additional $50,000 personal loan, the lender required the borrowers to pledge their personal stock portfolio as security. Id.
\textsuperscript{223} Id. at 530-31, 515 A.2d at 757.
\textsuperscript{224} Id. at 531, 515 A.2d at 758.
\textsuperscript{225} Id.
\textsuperscript{226} Id. at 527, 515 A.2d at 756.
\textsuperscript{227} Id. at 537, 515 A.2d at 761. The court noted that the lender expressly agreed to process the loan application and “lock in” the 11 7/8\% interest rate. Id. The lender argued that there was no consideration, the $144 being an out-of-pocket expense. Id. The court determined that the contract was supported by two kinds of consideration, the $144 application fee and the fact that the lender obtained a business advantage and potential benefit because after paying the fee, the borrowers in effect removed themselves from the market. Id. at 537-38, 515 A.2d at 761. As to the lender’s assertion that the fee was an out-of-pocket expense, the court noted that consideration is valid even if paid to a third-person. Id. at 537, 515 A.2d at 761.
of the Bank to process the loan application is the agreement to do so with reasonable care." 228 The court then examined whether the creation of the contract created a concomitant duty under the existing circumstances. 229 The court said that where there is pure economic loss, a duty of care will not be recognized unless an "intimate nexus" exists. 230 The Jacques court determined that such a relationship existed, citing (i) the extraordinary financing provisions between the parties, 231 and (ii) the fact that the banking industry is a business affected with a public interest. 232

First Federal Savings & Loan Association v. Caudle 233 also involved an allegation of negligence in processing a loan application. 234 In Caudle, the borrowers approached the lenders to inquire about a home loan. 235 The borrowers learned that they could not afford the loan payments of the conventional loan because of the high interest rates. 236 The parties then discussed the possibility of qualifying for an FHA 235 loan. 237 The lender agreed to process the necessary papers to see if the borrowers qualified for such a loan. 238 Several months later, a bank officer informed both the borrowers and their contractor that the loan was approved, and shortly thereafter construction began on their home. 239 When the house was nearly complete, the borrowers learned for the first time that their FHA loan had not been approved. 240 After the home

228. Id. at 540, 515 A.2d at 762.
229. Id.
230. Id. at 534, 515 A.2d at 759.
231. Id. at 540, 515 A.2d at 762. The court noted that the "rather extraordinary financing provisions contained in the real estate sales contract, and thereby integrated into the loan application, left the Jacques particularly vulnerable and dependent upon the Bank's exercise of due care." Id.
232. Id. at 541, 515 A.2d at 763. The court quoted an Oklahoma Court of Appeals decision, saying:

"Banks exist and operate almost solely by using public funds and are invested with enormous public trust. Their financial power within the community amounts to a virtual financial monoply [sic] in the field of money lending. The legislature has carefully defined their corporate charge within finite limits in direct proportion to their power." Id. at 542, 515 A.2d at 763 (quoting Djowharzadeh v. City Nat'l Bank & Trust Co., 646 P.2d 616, 619 (Okla. Ct. App. 1982)).
233. 425 So. 2d 1050 (Ala. 1982).
234. Id. at 1052.
235. Id. at 1050.
236. Id.
237. Id. at 1051. "A[n FHA] 235 loan allows low income borrowers who qualify to have a portion of the interest on their home construction loan subsidized by the federal government." Id. at 1051.
238. Id.
239. Id.
240. Id. The court noted that the lender first stated the reason the loan had not been approved was the fact that the borrowers had purchased a new car. Later, the lenders were told they had not qualified because the husband's income was too high. Id.
was completed and had received a final inspection, the contractor was informed that the borrowers' loan had not been approved. The borrowers then obtained a 30-year Veteran's Administration (VA) loan, at 14 1/2 percent interest, to pay the contractor. This new loan resulted in monthly payments of $436.10. Evidence produced at trial indicated that the FHA financing would have resulted in monthly payments of $197.

A jury awarded the borrowers $22,500. The issue on appeal was "whether a statement made by a lender's agent to prospective home buyers that they had been approved for an FHA 235 loan, when they, in fact, had not been approved, is actionable . . . ." The court held that even though the lender "was under no duty to help procure a federally subsidized loan . . . once it voluntarily agreed to assist [the borrowers], it was required to act with due care."

In *High v. McLean Financial Corp.*, plaintiffs claimed that the defendant's agents "constantly assured" plaintiffs that the lender had approved their loan application. A third party later notified them in writing that the bank had denied their application. The loan applicants brought suit against the lender alleging breach of contract, violation of the Equal Credit Opportunity Act, fraud and intentional misrepresentation, breach of fiduciary duty, and negligence. Citing *Jacques*, the court held that under District of Columbia law, the lender owed a duty of care to loan applicants where the lender accepted the applicants' processing fee.

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241. *Id.*
242. *Id.*
243. *Id.*
244. *Id.* at 1052.
245. *Id.* at 1053.
246. *Id.* at 1050.
247. *Id.* at 1052. The court noted that the jury could have found the lender's actions negligent and the borrowers' desire to construct a new home "predicated on their receiving a low interest loan which they could afford." *Id.* at 1052-53. *But see* Brasher *v. First Alabama Real Estate Fin., Inc.*, 447 So. 2d 682 (Ala. 1984) (borrowers could not recover damages from lender on the theory that it was obligated to obtain permanent financing once it began to do so by having a previous lender transfer borrowers' file, since there was never an oral or written agreement to obtain such financing).
249. *Id.* at 1563.
250. *Id.*
251. *Id.* at 1570. The court added:
Defendant's own alleged behavior supports this conclusion. The Complaint alleges that defendant extended assurances that there were 'no problems' with plaintiffs' application; this alleged statement implies that defendant actually examined whether problems existed . . . . [D]efendant's alleged acknowledgment of the application, and alleged attention to the application, show that defendant understood itself to have a duty to plaintiffs.
9. Negligent Approval of a Loan Application

A bank generally owes no "duty of due care" in its decision to approve a loan sought by the borrower for a risky business venture. In Wagner v. Benson,252 the borrowers alleged that they suffered foreseeable harm from the lender's negligence in loaning them money.253 Specifically, they alleged that the lender should have known that the borrowers were inexperienced investors undertaking a risky venture.254 A California court held that the lender was not sufficiently involved in the borrowers' enterprise, a ranching operation, to impose a duty of care on the lender for negligently loaning money.255 The court noted:

Liability to a borrower for negligence arises only when the lender "actively participates" in the financed enterprise "beyond the domain of the usual money lender." Normal supervision of the enterprise by the lender for the protection of its security interest in loan collateral is not "active participation." The Bank's limited involvement in the [enterprise] falls far short of the extensive control and shared profits which give rise to liability.256

Similarly, the Supreme Court of Wisconsin in Gries v. First Wisconsin National Bank257 held that where the evidence failed to show that the lender made misrepresentations, that the lender possessed unique information regarding the transaction that it withheld from the borrowers, or that the borrowers were incompetent, infirm or otherwise peculiarly dependent on the advice of the lender, the lender was not liable for negligently loaning money.258

In Production Credit Association v. Croft,259 the borrowers claimed that the lender was negligent for making loans that the lender knew, or should have known, the borrowers could not repay.260 The court held that

253. Id. at 35, 161 Cal. Rptr. at 521.
254. Id.
255. Id.
256. Id.
257. 84 Wis. 2d 774, 264 N.W.2d 254 (1978).
258. Id. at 779-80, 264 N.W.2d at 257. The court noted:
[None of the evidence presented] by the plaintiffs can obscure the basic fact that it was the plaintiffs who borrowed the money to open a business. They called the bank; they prepared a proposal; they applied for the loan; they invested the money in the business. Although the failure of the business is unfortunate for both the plaintiffs and the bank, it was a risk which the plaintiffs assumed, and which can not be shifted to the bank.

Id. at 780, 264 N.W.2d at 257.
259. 143 Wis. 2d 746, 423 N.W.2d 544 (Ct. App. 1988).
260. Id. at 757-58, 423 N.W.2d at 548.
the lender did not owe a fiduciary duty to the borrowers, and denied recovery.261

10. Negligent Failure on the Part of a Construction Lender to Detect Defects and to Notify the Homebuyer-borrower of Those Defects

One variation on the normal lender liability case occurs where a homebuyer sues either his mortgage lender or the construction lender alleging that it was negligent for failing to detect and warn of defects during construction. Under this theory, plaintiffs have enjoyed little success.

In Connor v. Great Western Savings & Loan Association,262 the court held that the lender owed a duty to purchasers of new homes to exercise reasonable care to see that the homes were built free of “major structural defects.”263 Connor is distinguishable from most fact patterns due to the lender’s extreme involvement in the construction process. In Connor, the bank financed the developer’s purchase of the land. The bank required the developer to submit plans and specifications and suggested selling prices. The bank also held a right of first refusal to supply mortgage loans to purchasers, and received loan fees from the developer for every buyer who obtained financing. If the purchaser obtained financing elsewhere, the construction lender was entitled to receive fees and interest from the developer.264

Homeowners brought suit against a savings and loan association seeking damages for breach of fiduciary duty in Clark v. Kansas Savings & Loan Association.265 Specifically, plaintiffs alleged that the defendant breached its fiduciary duty when it failed to inspect the house during construction.266 The plaintiff claimed that the builder constructed two bedrooms smaller than the plans required and the defendant failed to discover the undersized rooms.267 Applying Kansas law, the court held that the making of periodic inspections on the construction premises, without further involvement, con-

261. Id. at 749-53, 423 N.W.2d at 546-48. The appellate court upheld the trial court’s dismissal of the negligence claim for failure to state a claim upon which relief could be granted. Id. at 758, 423 N.W.2d at 548. The court said that the debtor’s counterclaims for negligence and breach of fiduciary duty were “so ‘inextricably woven’ that they present[ed] but one claim,” and declined to offer further analysis, except to say that its analysis under the fiduciary duty claim was equally applicable to the negligence cause of action. Id. The court denied recovery based on a breach of fiduciary duty. Id. See supra notes 206-10 and accompanying text.

262. 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968).
263. Id. at 866, 447 P.2d at 617, 73 Cal. Rptr. at 377.
264. Id. at 860-61, 447 P.2d at 613-14, 73 Cal. Rptr. at 373-74.
265. 608 S.W.2d 493 (Mo. Ct. App. 1980).
266. Id. at 494.
267. Id.
stitutes normal procedures and did not subject the lender to liability.268

In Allison v. Home Savings Association,269 the plaintiffs, homeowners, sued the construction lender for breach of an implied warranty of fitness and for negligence.270 The Missouri Court of Appeals suggested that under the negligence cause of action, the defendant did not owe the plaintiff a duty of care because its activities did not exceed those of the normal lender.271 The Allison court also noted that the Missouri legislature, like other legislatures, had limited "the liability of a construction lender to cases involving misrepresentation or activities outside the scope of a lender."272 Missouri Revised Statutes Section 369.264 provides:

An association which makes a loan, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property for sale or lease to others, shall not be held liable to the borrower or to third persons for any loss or damage occasioned by any defect . . . or for any loss or damage resulting from the failure of the borrower to use due care . . . unless the association has knowingly been a party to misrepresentations with respect to such real or personal property.273

Thus, under Missouri law, a savings and loan association does not owe the homebuyer-borrower a duty of care to detect and warn of defects unless it is involved in a scheme to defraud the homebuyer-borrower or its connection with the developer clearly goes beyond the normal scope of activities of a construction lender.

268. Id. at 496.
269. 643 S.W.2d 847 (Mo. Ct. App. 1982).
270. Id. at 850. Specifically, plaintiffs asserted that the lender owed them a duty to detect and warn of defects in construction. Id. at 851. The plaintiffs tried their case solely based on the theory of breach of a vendor's implied warranty of habitability. Id. The court noted that the question of whether the lender was liable for negligence based on a duty to detect defects and warn was not properly preserved for their determination. Id. at 852. Nevertheless, the court addressed this issue. Id.
271. Id. at 852. The court noted:
Here, the record shows only that Home Savings financed the construction of the subdivision, acquired title to the two properties after their construction, and later sold them. That does not constitute involvement in the development and construction phases such as would justify a result similar to that in Connor. Moreover, subsequent cases in California and other jurisdictions have declined to impose liability on construction lenders whose activities do not clearly exceed those of a normal lender. Id.
272. Id.
273. Mo. REV. STAT. § 369.264 (1986). Note that the term "association" pertains only to savings and loan associations. See Mo. REV. STAT. § 369.014(3) (1986).
11. Negligent Administration of a Loan

Negligent administration of a loan generally occurs under a construction loan. Often the borrower runs out of funds to complete the project. The following cases discuss generally the administration of loans, and the type of conduct by the lender that might give rise to a negligence claim.

In Brunswick Bank & Trust Co. v. United States,274 the lender sued the Farmers Home Administration, after the borrower defaulted, seeking reimbursement under the terms of a guaranty.275 The government denied liability, claiming that the bank had committed fraud and misrepresentation in securing the guaranty and had negligently serviced the loan.276 The court held that the lender had negligently serviced the loan.277 The court noted:

[T]he evidence clearly indicates that the bank disregarded many of its most basic servicing obligations. Its predefault servicing activities indicate little concern for reasonable banking practices, and there can be no doubt that the government has shown the bank's servicing of the loan to be negligent . . . . Because of the bank’s negligence, the proper hazard insurance was not obtained, large amounts of money intended for [the debtor corporation] were instead used for the personal benefit of the individual and corporate guarantors, and apparently only about half of the necessary construction and acquisition and repair of machinery actually took place. The bank's negligence thus had a direct bearing on the failure of the [debtor's] venture. Accordingly, we hold that the bank is not entitled to recover on the loan note guaranty.278

In Canterbury Realty & Equipment Corp. v. Poughkeepsie Savings Bank,279 the court held that the lender was not liable to the guarantor of a note for negligence in administering a commercial loan.280 In Canterbury, the lender extended a revolving line of credit to the borrower, Canterbury Realty.281 The borrower assigned its accounts receivable to the lender under a "lock box" arrangement as security for the loan.282 C.I., the parent corporation of the borrower, and two of C.I.'s officers and shareholders guaranteed the loan.283 Evidence at trial showed that the borrower's credit

274. 707 F.2d 1355 (Fed. Cir. 1983).
275. Id. at 1356-57.
276. Id. at 1357.
277. Id. at 1363.
278. Id.
280. Id. at 109, 524 N.Y.S.2d at 536.
281. Id. at 103, 524 N.Y.S.2d at 532.
282. Id. A lock box arrangement is a tool often employed by lenders. Under the arrangement in this case, vendees of the borrower made payments directly to a post office box in the lender's name. Id. at 103-04, 524 N.Y.S.2d at 532. Under the loan agreement, the lender was obligated to apply the receipts from the lock box against the borrowers credit line indebtedness within three days of receipt. Id.
283. Id.
limit exceeded the authorized amount and was in part attributable to the lender's failure to give timely credit to the borrower's receivables that it collected.284 The plaintiffs, the borrower and its parent corporation, brought suit, alleging among other things that the lender negligently administered the loan.285

The court ruled that the trial court should have dismissed the negligence cause of action because the lender owed no duty to the guarantor CI and the borrower had dismissed the action in bankruptcy.286 The court, however, did not necessarily exclude future suits brought by borrowers against lenders under this cause of action. In dicta, the court noted: "To whatever extent the Bank may have owed a duty of care in managing the loan, contractually based or otherwise, the duty was owed solely to the borrower, Canterbury."287 Thus, a New York court might recognize a negligence cause of action brought by a borrower against a lender.

12. Breach of Duty of Good Faith and Fair Dealing as Basis for Tort Claim

The doctrine of good faith and fair dealing, as indicated earlier, is primarily a contract cause of action. This common-law doctrine, which is implied in all contracts,288 requires "that neither party will act to impair the right of the other to receive the benefits which flow from their agreement or contractual relationship."289 Missouri Uniform Commercial Code (UCC) section 1-203 provides that "every contact or duty within this chapter imposes an obligation of good faith in its performance or enforcement."290 Plaintiffs now seek to assert this duty of good faith and fair dealing as

284. Id. at 104-05, 524 N.Y.S.2d at 533.
285. Id. at 105, 524 N.Y.S.2d at 533.
286. Id. at 109, 524 N.Y.S.2d at 536. The court said:
As to C.I. [the parent corporation], the Bank owed no duty of care to it to monitor the affairs of and manage the loan to Canterbury, C.I.'s wholly owned subsidiary. Since C.I.'s damage, if any, in this regard is entirely based on the loss in the value of its investment as the sole stockholder in Canterbury, it has no standing to prosecute this claim for a tortious injury to Canterbury.
Id.
287. Id.
the basis for not only a contract cause of action, but for the basis of a tort claim as well.\textsuperscript{291} The following cases examine this issue.\textsuperscript{292}

The application of a tort duty of good faith first arose in insurance cases. In \textit{Rawlings v. Apodaca},\textsuperscript{293} the court allowed an insured to recover in tort based on the insurer's breach of the duty of good faith.\textsuperscript{294} The court noted that

a tort action for breach of the implied covenant is more often recognized where the contract creates a relationship in which the law implies special duties not imposed on other contractual relationships. These relationships are "characterized by elements of public interest, adhesion, and fiduciary responsibility."\textsuperscript{295}

The \textit{Rawlings} court also noted that the law sometimes imposes tort liability where the relationship is common carrier-guest, innkeeper-guest, physician-patient, and attorney-client.\textsuperscript{296} The court concluded that the breach of insurance contracts, when done in bad faith, makes tort remedies appropriate.\textsuperscript{297} The court summarized its holding, saying:

[S]ome breaches of the implied covenant may not provide the basis for tort recovery, although they may give rise to an action on the express covenant in which contract rules of damages would be applicable. But in special contractual relationships, when one party intentionally breaches the implied covenant of good faith and fair dealing, and when contract remedies serve only to encourage such conduct, it is appropriate to permit the damaged party to maintain an action in tort and to recover tort damages.\textsuperscript{298}

The court recognized that unless a tort duty existed, parties have an incentive to breach performance under the contract.\textsuperscript{299} The court noted that this is particularly true in insurance cases.\textsuperscript{300}

The court then addressed whether the application of punitive damages was appropriate under a tortious breach of the duty of good faith and


\textsuperscript{293} 151 Ariz. 149, 726 P.2d 565 (1986).

\textsuperscript{294} \textit{Id.} at \textit{——}, 726 P.2d at 576.

\textsuperscript{295} \textit{Id.} at \textit{——}, 726 P.2d at 574 (quoting Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 36 Cal. 3d 752, 768, 686 P.2d 1158, 1166, 206 Cal. Rptr. 354, 362 (1984)).

\textsuperscript{296} \textit{Id.} at \textit{——}, 726 P.2d at 575; see also \textit{Restatement (Second) of Torts} § 314A (1965); \textit{Prosser, supra} note 86, § 92, at 660-62.

\textsuperscript{297} \textit{Rawlings}, 151 Ariz. at \textit{——}, 726 P.2d at 576.

\textsuperscript{298} \textit{Id.} at \textit{——}, 726 P.2d at 576.

\textsuperscript{299} \textit{Id.} at \textit{——}, 726 P.2d at 576.

\textsuperscript{300} \textit{Id.} at \textit{——}, 726 P.2d at 576.
fair dealing. The court began this analysis by noting that “[i]t is sufficient to establish the tort of bad faith that the defendant has acted intentionally” and that this action “may fall short of what is required for punitive damage award.” The court restricted the availability of punitive damages to cases in which the “defendant’s wrongful conduct was guided by evil motives.”

In Commercial Cotton Co. v. United California Bank, the California Court of Appeals held that banks owe a tort duty of good faith to depositors of non-interest bearing checking accounts. In Commercial Cotton, depositors brought suit when the lender allegedly debited the depositors account due to an unauthorized signature. The depositor sued for breach of good faith in tort because the bank refused to reimburse the depositor, claiming that the statute of limitations barred recovery. The court analogized the banking industry to the insurance industry, noting: “[B]anking and insurance have much in common, both being highly regulated industries performing vital public services substantially affecting the public welfare . . . The relationship of bank to depositor is at least quasi-fiduciary . . .”

301. Id. at ___, 726 P.2d at 577.
302. Id. at ___, 726 P.2d at 577.
303. Id. at ___, 726 P.2d at 578. The court noted:
Something more than the mere commission of a tort is always required for punitive damages. There must be circumstances of aggravation or outrage, such as spite or ‘malice,’ or a fraudulent or evil motive on the part of the defendant, or such a conscious and deliberate disregard of the interests of others that the conduct may be called wilful or wanton. Id. at ___, 726 P.2d at 578 (quoting Prosser, supra note 86, § 2, at 9-10) (emphasis added) (citations omitted).
304. Id. at ___, 726 P.2d at 578. The court further noted:
[Punitive damages] are recoverable in bad faith tort actions when, and only when, the facts establish that defendant’s conduct was aggravated, outrageous, malicious or fraudulent. Indifference to facts or failure to investigate are sufficient to establish the tort of bad faith but may not rise to the level required by the punitive damage rule.

Id. at ___, 726 P.2d at 578 (citations omitted).
306. Id. at 516, 209 Cal. Rptr. at 554. Prior to Commercial Cotton, California had extended the tort action to include insurance contracts and other “special relationships.” See also Seaman’s Direct Buying Serv., Inc. v. Standard Oil Co., 36 Cal. App. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (allowing recovery in tort for breach of implied covenant of good faith in an ordinary commercial contract).
308. Id. at 514, 209 Cal. Rptr. at 552-53.
309. Id. at 516, 209 Cal. Rptr. at 554. As to the suggestion that the bank provides a service to the depositor, the court noted:
A depositor in a noninterest-bearing checking account, except for state or federal regulatory oversight, is totally dependant on the banking institution to which it entrusts deposited funds and depends on the bank’s honesty.
In *First National Bank v. Twombly*, a bank initiated an action to recover on a delinquent promissory note, and the borrower counterclaimed, arguing that the bank's acceleration of the maturity date and subsequent wrongful offset was in bad faith. At trial, the jury awarded borrower $4,000, which the court offset against the balance owed on the note, the interest accrued, and the bank's attorney's fees. In addition to actual damages, the borrowers sought punitive damages, but the trial court did not allow plaintiffs to submit this to the jury. The borrowers appealed. The Montana Supreme Court held that "[w]hen the duty to exercise good faith is imposed by law, rather than the contract itself . . . the breach of that duty is tortious." The court further held that the borrower may recover punitive damages if the bank's conduct is sufficiently culpable, and remedied for a trial on that issue.

Missouri plaintiffs have a much more difficult task in proceeding under this theory. In *Rigby Corp. v. Boatmen's Bank & Trust Co.* the Court held that there is no independent tort cause of action for breach of the U.C.C. duty of good faith. The Court noted: "The obligation of good faith appertains to the performance or enforcement of every *contract* duty under the Code. § 400.1-203. The remedy for breach of the obligation of good faith under the Code, §§ 400.1-203 and 400.1-208, accordingly, is a contract, and not a tort remedy."

and expertise to protect them. While banks do provide services for the depositor by way of monitoring deposits and withdrawals, they do so for the very commercial purpose of making money by using the deposited funds.

*Id.*

311. *Id.* at 67, 689 P.2d at 1227.
312. *Id.*
313. *Id.* at 67-68, 689 P.2d at 1227.
314. *Id.* at 68, 689 P.2d at 1227.
315. *Id.* at 73, 689 P.2d at 1230. In *Tribby v. Northwestern Bank*, 217 Mont. 196, 704 P.2d 409 (1985), the same court said:

[T]he jury heard evidence on the bank's conduct that might support a finding of reckless disregard for [the borrower's] rights; the bank stands in the position of superior bargaining power to its customer that was noted in *Twombly*; and the evidence might support a finding that the bank breached an obligation to [the borrower]. We are not holding that every contract or statutorily imposed obligation, alone, carries with it an implied covenant of good faith and fair dealing, the breach of which permits recovery in tort. We hold only that the District Court, under these circumstances, did not err when it instructed the jury to consider recovery under tort principles, and, accordingly, punitive damages.

*Id.* at 211-12, 704 P.2d at 419.
316. *Twombly*, 213 Mont. at 211-12, 689 P.2d at 419.
317. *Id.* at 211-12, 689 P.2d at 419.
318. 713 S.W.2d 517 (Mo. Ct. App. 1986).
319. *Id.* at 527.
320. *Id.* at 536.
The Court upheld the summary judgment on the tort cause of action for breach of good faith.321 The Rigby court noted, however, that plaintiffs may bring a tortious breach of good faith claim where they can point to non-Code law for a remedy.322 Rigby's significance can also be found in its definition of the good faith standard in Missouri. Defendant's conduct must be "honesty in fact," regardless of the "unreasonableness of that conduct by any commercial standard."323

III. PUBLIC POLICY RATIONALE FOR AND AGAINST LIMITING LENDER LIABILITY

Lenders, like other businesses and professions, are judged by standards of good faith (under contract law) and reasonableness (under tort law). There is no doubt that litigation of lender liability suits has dramatically increased over the past decade. There is debate, however, over whether the traditional justice system of trial by juries can effectively handle these actions. Lenders, once protected and favored by the judicial system, now cry "FOUL!" They allege that both judges and juries are naturally sympathetic to the plaintiffs, creating an unfair playing field: "Jurors typically perceive the farmer-banker relationship as David against Goliath and, as a result, routinely award large verdicts to punish banks for what they think is malicious or outrageous conduct."324

To what standards should society hold the banking industry? Traditionally, defendant's actions are measured by objective standards, i.e., did the loan officer do what a reasonable person would do "under the same or similar circumstances?"325 Critics of lender liability suggest that the law should judge banks by a lesser standard—subjective reasonableness. The inquiry under a subjective standard is whether the lender believed his actions or judgment was appropriate.

Should banks, because of the role they play in the economic world, be judged by different standards that other defendants? Will the application of normal tort principles against lenders cause economic turmoil and do more harm than good?

One author suggests that in those decisions effecting the extension of new credit after a loan is due, banks should be judged by a subjective test rather than the traditional objective reasonableness test. The author argues:

321. Id. at 535-37. The Court also upheld the summary judgment on the fraud and prima facie tort claims. Id. at 548.
322. Id. at 536-37. Since the plaintiff in Rigby failed to plead or otherwise assert a non-Code breach, he failed to state a cause of action and summary judgment was proper. Id.
323. Id. at 526-27.
325. See Prosser, supra note 86, at 175.
To measure the lender's decision not to extend new credit after a loan is due and in default against an objective reasonableness standard would place an undue burden on the lenders. While a lender must objectively act in good faith under the terms of an existing loan, the requirement to act in good faith when making a new loan after the existing loan is due would place a burden on the lender by making it difficult to terminate credit. Thus, a lender's decision not to extend new credit, from an objective standpoint, may not have been commercially reasonable, but, from a more subjective standpoint, may have been made by the officer of the lender based on his or her fear that the bank's position is jeopardized. 326

If, in fact, the borrower is in default, the application of objective standards to the lender would net the same result as the foregoing approach. When using an objective test, the court asks the jury whether a reasonable person, knowing all of the facts known by the defendant, would have acted in the same way. If such a person knows that the borrower is already in default, it is reasonable not to extend new credit.

This same logic applies to the extension of new credit if the loan officer knows that the borrower's trustworthiness is questionable, and suspects that the borrower will not meet its financial obligations. Any loan officer, being a "man of ordinary prudence" 327 and knowing these same things would be hesitant to extend financing.

The author cited above also suggests that lenders should make their credit decisions based on their own internal standards which exist at the time. 328 Under such an approach, the lender is not liable unless it applies these internal standards in some arbitrary or capricious manner. 329 If this theory were to apply, each lender in essence would determine its own lending standards rather than adhere to an industry-wide standard. Certainly, this type of approach is not in the best interests of society and would be a throwback to the dark ages of tort law. 330

326. See Bahls, supra note 8, at 258.
328. The author suggests:
Borrowers can have no more justifiable expectation than to expect that the lender will make the credit decision in accordance with its standards at the time the credit decision is to be made. Because of the nature of lending standards, the standards should not be measured against an objective reasonable lending standard.
Bahls, supra note 8, at 265.
329. Id. at 266.
330. Prosser writes:
The whole theory of negligence presupposes some uniform standard of behavior. Yet the infinite variety of situations which may arise make it impossible to fix definite rules in advance for all conceivable human conduct. The utmost that can be done is to devise something in the nature of a formula, the application of which in each particular case must be left to the jury, or to the court. The standard of conduct which the
Critics of lender liability suggest that under the current system, recovery against lenders will create unforeseen bank losses. In particular, their concern is with the amount of punitive damages. One critic noted: "We're getting huge punitive damage verdicts. This is a problem for the industry, because there's no way a bank can figure into its pricing structure the cost to the institution of a punitive damage award." These unforeseen losses, they argue, are particularly devastating to already troubled small banks and savings and loan institutions.

There is also a concern that the fear of lender liability losses will force banks to give fewer loans, especially to those with only marginal credit ratings—like entrepreneurs, small businesses and young people. One author suggests:

As in any other business, lenders make decisions based on the relative amount of risk and reward. Because the amount of a lender's reward (rate of interest) is limited by law (usury statutes), lenders are hesitant to make loans unless the amount of risk can be controlled. Risks entail the possibilities of failure of the farm, decline in value or dissipation of the collateral, bankruptcy of the farmer; but should not include excessive risks of lawsuit if the lender denies further credit after the loan is due. In those cases where the risks associated with extending credit are nearly equal to the rewards, additional risk such as a substantial expansion of the theory of lender liability will tip the balance against extending credit to farmers or other borrowers if the lender believes they are litigious. If the balance is tipped in that direction, the marginal borrowers who need credit the most may be excluded from credit markets.

Critics also charge that many lender liability suits lack merit. Instead, critics suggest that bankrupt debtors use them merely as stalling tactics to delay foreclosure suits brought by the lender. Similarly, critics suggest that borrowers use these suits, or the threat of filing, as leverage while negotiating an agreement with the lender.

Finally, critics charge that lenders are in essence becoming insurers, even though it is the borrower who is in the best position to prevent financial loss. To shift the losses to the lender, they suggest, is simply unfair. "The costs of incorrect decisions, whether or not the decisions
were warranted at the time, should be borne by those who have the greatest opportunity to control the risks, in most cases, the borrowers."

Some states, recognizing these concerns, and feeling the pressure of lobby efforts by the banking industry, have attempted to limit lender liability by statute. These statutes generally put a cap on punitive damages or have amended their statute of frauds provision so as to prevent enforcement of oral commitments to lend above a specified amount. Naturally, the plaintiff’s bar in these states have lobbied vehemently in opposition to such legislation. Advocates of lender liability argue that by limiting liability, the threat of being sued has a minimal deterrent effect.

While some of the criticisms expressed represent valid concerns, they apply to the tort recovery system as a whole, not just suits brought against lenders. Within the tort system, as it now exists, lenders should not be treated differently from other defendants. This fact becomes evident when one remembers that the concept of “lender liability” largely represents the application of old principles against lenders, not new causes of action. In other words, the legal theories are not merely current fashionable causes of actions which might quickly fade, but rather theories plaintiffs have used for centuries. Should the law hold banks, managed and staffed by Ivy League MBA’s to lower standards of reasonableness than other businesses? The answer is simply no—that within the current tort recovery system lenders, despite their important role as economic middleman, should be treated like everyone else. Lenders should not be insurers of the borrower’s financial success, but instead should bear part of the financial burden when their own actions contribute, in a significant part, to the borrower’s economic problems.

IV. WHAT BANKS SHOULD DO TO PROTECT THEMSELVES

A. Documentation

Many commentators, as well as those individuals on the “Lender Liability Seminar Circuit,” suggest that the best protection against lender
liability is effective documentation. While effective documentation is a necessary part of an "overall protection plan," it is not in itself the solution. To the contrary, documentation may have just the opposite effect—it might create liability, or, more precisely, define the standard by which juries will judge the lender. One author has noted:

Of course, the contents of loan manuals and the curricula of seminars are matters discoverable by an adversary in a lender liability suit, and in them will be found not a general standard of good faith and fair dealing, but a detailed description of the conduct which the lending institution finds appropriate.

The risk is that the lender-defendant will have thus defined a precise standard of conduct for its own loan officers, one by which their conduct will later be judged in the courtroom. And failure to follow the detailed instruction in a loan manual—or the recommendations of an expert panel—may be taken (and possibly mistaken) as evidence of bad faith or unfair dealing. What may truly be nothing more than a banker exercising sound judgment, based upon years of experience, in shaping loan policy or practice to fit the needs of a potential or actual borrower can thus become a basis for lender liability.\(^{337}\)

The author quoted above quite properly understands the importance of effective documentation. What is important is not the number of things that the lender documents, but rather the type of things that it chooses to document. For example, a lender should document the subjective reasons that it decided to terminate credit or not to extend credit. Documentation should bolster the lender's case, not provide a smoking gun for the plaintiff's attorneys to uncover during discovery. Thus, the documentation must reflect intelligent, calculated decisions made by the lender. It is therefore necessary to first create an "overall protection plan," designed to limit the lender's liability. Once the protection plan is working, the lender should then document how it has effectively executed the plan.

**B. Developing a Protection Plan**

In developing an overall protection plan designed to limit their liability to borrowers, lenders should do the following: (1) Always be upfront and honest with the borrower, even though they may lose a client; (2) notify the borrower promptly that he is in default or that the bank will not extend additional credit (i.e., Don't delay the inevitable!); (3) consider the use of exculpatory language, especially where the lender and borrower are on relatively equal bargaining ground; (4) treat all accepted loan applications as valid contracts; (5) purchase liability insurance; (6) consider including jury waivers in the loan agreement; (7) consider the use of arbitration clauses; (8) make sure they are using current document forms approved

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337. McCabe, supra note 1.
https://scholarship.law.missouri.edu/mlr/vol54/iss4/6
by legal counsel; and (9) develop a "risk-management program." 

Be upfront and honest with the borrower. No one likes to be the bearer of bad news, and no one likes to turn away a prospective client. Nevertheless, loan officers should be upfront with the borrower—even if it means telling them that the bank cannot provide new or additional financing. Do not unreasonably raise the borrower's expectations, because to do so risks a lawsuit based on misrepresentation.

Notify the borrower promptly when trouble shows up. Common sense dictates notifying the borrower early of pending trouble, so she may have time to make alternative arrangements. By failing to notify the borrower, especially under a line of credit loan, the bank may be subjecting itself to a claim of bad faith.

Consider the use of exculpatory language. Exculpatory language, such as expressly agreeing that the lender does not owe a fiduciary duty to the borrower and is not liable for acts which might otherwise constitute negligence, may prove fruitless. In fact, such contractual language may be damaging to the lender if the borrower is able to introduce it into evidence. Nevertheless, where the parties are on equal bargaining ground the use of such language may be useful to effectively allocate the risks by contractual agreement. By no means should the lender rely on such language as a safety net, but should consider its inclusion into loan agreements.

Treat loan application, once accepted, as a valid contract. Remember, once the lender has accepted the application along with the processing fee, there is a good chance it has entered into a binding contractual agreement. The lender should treat its relationship with the borrower as if a contractual relationship exists. It should act in good faith and deal fairly with its borrowers to diminish its chances of being sued.

Consider purchasing liability insurance designed specifically to meet your needs. Lenders might consider purchasing insurance designed especially to protect them against lender liability. Comprehensive general liability policies generally give little or no coverage to situations in which borrowers can hold lenders liable. In addition, directors' and officers' liability often fails to provide the necessary coverage.

Consider including jury waivers in the loan agreements. The possibility of being hit with a large plaintiff's verdict is more likely to occur where

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338. See generally McCabe, supra note 1.
339. See Ellis & Gray, Lender Liability for Negligently Processing Loan Applications, 92 Dick. L. Rev. 363, 389 (1988). The authors state: "When a lender holds itself out to the public as a source of loans based on predetermined eligibility standards, the lender implicitly promises to make loans to qualified applicants in the amount, at the rate, and for the term advertised . . . ." Id.
341. Id.
a jury is involved and thus the lender should consider including jury waivers in the loan documents. Nevertheless, inclusion of jury waiver language is like a two-edged sword—if the court enforces the waiver, it might save the lender a lot of money if it is ultimately liable. If for any reason, however, the court does not uphold the waiver, such attempt may infuriate the jury which may lead to an even larger verdict. Lenders should use these with great care and understand the risks involved.342

Consider using arbitration as a means of settling disputes that arise with your borrowers.343 Currently only a small number of commercial lenders routinely put arbitration clauses into their loan agreements.344 These arbitration agreements provide that if a dispute arises, both parties agree to settle it through binding arbitration.345 Advocates of arbitration clauses suggest that if lenders insert them into loan agreements the process for working out disputes is in place long before the disputes arise, saving the parties both time and money.

Despite the attractiveness of arbitration agreements, banks have been reluctant to put them into loan agreements, though this may be changing. To some lenders, using arbitration agreements is like using a prenuptial agreement—who wants to talk about impending bad times before they happen?346 Perhaps another reason banks in the past have reluctant to arbitrate was their ability to outlast most borrowers in expensive litigation.347 This sense of security may no longer hold true, especially since plaintiff's firms are now willing to take these cases on contingency fees. This, along with the increasing number of large jury verdicts, may cause banks to rethink their position on binding arbitration agreements. One article suggests that it may be the borrower's attorney, rather than bank counsel, who objects to the imposition of an arbitration clause in a consumer loan.348

Critics of arbitration clauses point to the following shortcomings: (1) the inability to appeal unless the decision is "egregious;" (2) the tendency of the arbitrator to "split the baby;" and (3) the possibility that the one arbitrator may be biased or irrational.349 As to the threat of one irrational arbitrator, some suggest that this problem can be overcome by using a

342. See McCabe, supra note 1, at ____.
344. Id. One such bank is the Bank of America, San Francisco.
346. Id.
347. Id.
348. Id.
349. Id.
panel of three arbitrators. Lenders should give strong consideration to using arbitration as a means of settling their disputes with borrowers, keeping in mind the criticisms noted above.

*Maintain and use only current loan documents.* It almost goes without saying that lenders should use only up-to-date loan forms that their legal counsels have approved. In addition to prospectively using current forms, lenders may want to review existing loan agreements, especially those that might suggest that the lender has the right to exercise some control over the borrowers.

Finally, lenders should develop a risk management program. One author notes that an effective risk prevention program must include an early warning system, where the lender monitors those borrowers who appear unhappy. When signs of unhappiness arise, lenders are then able to confront the problem before the friction escalates and ends in a costly lawsuit.

In addition to monitoring the satisfaction of its borrowers, the lender should see to it that the borrower understands with whom he or she is dealing. The bank is not merely an entity but rather an organization with a definite chain of command. The borrower should know who to talk to on a day to day basis, and who to complain to when he or she is dissatisfied. The more knowledgeable the borrower is about the internal structure of the lender, the less likely problems in communication will exist. One commentator notes:

What is required, in short, is a recognition that any lending institution seriously concerned about its exposure to lender liability should undertake a comprehensive review not only of its documentation, but of every step in its lending and loan enforcement processes, with effective risk management the goal. That review, and the crafting of a risk management program, should be undertaken under the guidance of, and with the benefit of counseling from, lawyers whose experience is in the courtroom, who know how to create and preserve evidence of good faith and fairness in a lending relationship from its inception to its demise.

V. Conclusion

The 1980's have seen a drastic change in the relationship between lenders and their borrowers. Due in part to the banking industry's own self-promotion, borrowers are no longer merely debtors but instead "clients," who expect the lender to treat them fairly and professionally. When treated unreasonably and backed into corners, borrowers no longer throw
their hands up in disgust. Instead, the borrower bites the hand that once fed them. At the very least, the “game has changed,” and lenders must learn the new rules to play.

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