Good Faith Theories of Lender Liability

Paul Matthew Jones
GOOD FAITH THEORIES OF LENDER LIABILITY

Borrowers are suing their lenders with increasing frequency and are often prevailing on the merits. The awards in successful suits have been large, sometimes quite spectacular. Courts base these recoveries on a variety of grounds, including federal statutes, the common law theories of duress, interference with contract, and fraud, and theories of fiduciary obligations between borrowers and lenders. Increasingly, courts and borrowers are resorting to another theory—that the lender did not abide by his obligation of good faith. All of those cases loosely coalesce under the term "lender liability." However, that term denotes more than a collective reference to theories of law; it describes a marked tendency of courts to apply well-established theories of law to the lender-borrower relationship for the first time.

This article examines the good faith theories in isolation from the other views of lender liability. The first section discusses the sources and scholarly interpretations of good faith. The section also introduces a theme running throughout this article, that good faith is a mechanism...
for protecting expectations. Section two discusses the scope of the good faith obligation in the lending transaction. The expansion into the line-of-credit cases is presented as an example of the tendency to broaden the scope of good faith and of the application of good faith theories to lending transactions. The third section presents the exemption from good faith obligations that follows the classification of a transaction as a “demand note.” Section four presents the debate in the case law over the standard by which good faith should be judged in lender liability cases. The final section analyzes the view that bad faith constitutes a tort and examines the potential application of this theory to lender liability cases. Each section investigates the interplay between the expectation-protection function of good faith and the particular aspect of the good faith theory which is discussed in the case law.

THE SOURCES OF GOOD FAITH

The notion of good faith is neither a recent innovation nor limited to the lender-borrower context. American case law has for some time imposed an implied obligation of good faith in every contract.7 Under this rule, a party to a contract keeps good faith by doing nothing which would deprive the other of the benefits of the deal.8 A highly developed body of law defining the obligation in specific transactions has developed. The Restatement Second of Contracts embraced the notion of an implied good faith obligation.9 Much like the Uniform Commercial Code (U.C.C.) provisions, it required good faith in the performance or enforcement of all contracts.10 Both the case law and the Restatement were vague on good faith, yielding guidance in certain fairly well-defined situations; a party exercising discretion was bound to use good faith, but no general, easily applied rule existed.

Most of the lender liability case law discussing good faith has been decided under U.C.C. provisions. The drafters of the Uniform Commercial Code expressly adopted the idea of good faith in fifty of the Code’s four hundred provisions;11 three have been fertile ground for the good faith theories. Section 1-20312 imposes the general obligation

8. Id. at 379-80.
10. Id.
12. La. R.S. 10:1-203 (1987) [hereinafter § 1-203]. Louisiana is in an extraordinary position with regard to good faith; this state has two statutory sources of the obligation—the article 1 provisions of the U.C.C. and La. Civ. Code arts. 1759 and 1983. While the
of good faith, stating that "(e)very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." In section 1-201(19), the Code defines good faith as "honesty in fact in the conduct or transaction concerned." As defined, good faith is determined by a subjective test. Section 1-208 addresses a clause frequently used by lenders, the so-called "insecurity clauses," which give lenders discretion to accelerate the instrument. When these clauses are exercisable "at will" or depend on the lender's insecurity, they can be exercised only in good faith. Since these three U.C.C. provisions form the basis for good faith theories of lender liability, the interpretations given them by the courts will determine the course of those good faith theories.

common law recognized good faith in fairly recent times, Louisiana's good faith provisions trace back to 1808. A healthy amount of jurisprudence has developed around these principles. See, e.g., Nat'l Safe Co. v. Benedict & Myrick, Inc., 371 So. 2d 792 (La. 1979); Waguespack-Pratt v. Ten-O-One Howard Ave., 449 So. 2d 657 (La. App. 4th Cir. 1984); Makofsky v. Cunningham, 576 F.2d 1223 (5th Cir. 1978).

As the civilian notions of good faith are generally considered much broader than those at common law, an interesting question remains as to which standard (if either) the Louisiana courts will apply. This paper proceeds on the assumption that the Commercial Code will be applied to the lending contract, a basically commercial transaction. On the civil code's good faith provisions, see generally 2 S. Litvinoff, Obligations §4 at 6, in 7 Louisiana Civil Law Treatise (1969); Tete, Tort Roots and Ramifications of the Obligations Revision, 32 Loy. L. Rev. 47 (1986).

13. La. R.S. 10:1-201(19) (1987) [hereinafter § 1-201(19)]. The U.C.C. also defines good faith in Article 2. As applied to "merchants," good faith means "honesty in fact and the observance of commercial standards of fair dealing in the trade." U.C.C. § 2-103 (not adopted by Louisiana) [hereinafter § 2-103]. A number of cases have refused to apply the broader standard of commercial reasonableness on grounds that lenders are not merchants. See, e.g., Van Bibber v. Norris, 419 N.E.2d 115 (Ind. 1981) ("sales transactions are more amenable to the establishment of 'reasonable commercial standards' than are the relations between secured parties and debtors"); Sievert v. First Nat'l Bank, 358 N.W.2d 409 (Minn. Ct. App. 1984) ("commercially reasonable conduct has no application under the [U.C.C.] to negotiating loan refinancing"). No court has considered the question thoroughly, and it is not implausible to classify lenders as merchants as a matter of definition. Nonetheless, the contrast between § 2-103 and § 1-201(19) is sometimes cited as a strong argument for a subjective standard. See infra notes 104-20.


15. Courts had formerly policed abuse of insecurity clauses by making the paper containing them nonnegotiable. Article 3 of the U.C.C. made it clear that instruments containing acceleration clauses were negotiable, and that the problem of abuse was to be handled under § 1-208. See U.C.C. § 3-109, official comment 4; 1 W. Hawkland, Uniform Commercial Code Series (1982) § 1-208:01 at Art. 1, p. 206.
The language of the U.C.C. provisions and the history of good faith in the American common law fail to resolve difficult questions arising from their application to concrete facts. Therefore, the writings of scholarly commentators and the U.C.C. drafters will assume importance in determining how good faith will be applied. Professor Farnsworth provides one of the more useful commentaries on the subject.\footnote{Farnsworth, supra note 11.} Farnsworth distinguishes between good faith purchase and good faith performance. Good faith purchase is a state-of-mind inquiry, closely akin to notice.\footnote{Id. at 668.} Examples of its application are in the doctrine of bona fide purchaser and in the test for holder in due course. Good faith performance is a much broader doctrine which enjoyed a renaissance in the U.C.C.\footnote{Id. at 669.} The implied term of good faith performance "[requires] cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations."\footnote{Id. at 671.}

Professor Summers argues for the broadest reading of good faith.\footnote{Summers, Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 201 (1968).} Courts should not attempt to define good faith, but should treat it only as an "excluder."\footnote{Id.} A definition of good faith will then emerge from cases excluding certain forms of conduct as bad faith.\footnote{Id. at 215.} The inquiry is not governed by preconceived guidelines, but is an ad hoc determination made by the trial courts:

If the obligation of good faith is to do its job, it must be open-ended rather than sealed off in a definition. Courts should be left free, under the aegis of a statutory green light, to deal with any and all significant forms of contractual bad faith, familiar and unfamiliar.\footnote{Id.}

Another commentator has tried to clear up the matter by resorting to more concrete theories. Professor Burton argues for an economic definition of good faith. A party acts in bad faith, in Burton's view, when he uses the discretion given him under the contract to take back some of the opportunities he has foregone.\footnote{Burton, supra note 7, at 387.}

The commentary is much more helpful in framing the standard by which good faith should be judged. Farnsworth takes note of the subjective standard apparently adopted in the general provisions of the Code

\begin{itemize}
  \item \footnote{Farnsworth, supra note 11.}
  \item \footnote{Id. at 668.}
  \item \footnote{Id. at 669.}
  \item \footnote{Id. at 671.}
  \item \footnote{Summers, Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 201 (1968).}
  \item \footnote{Id.}
  \item \footnote{Id.}
  \item \footnote{Id. at 215.}
  \item \footnote{Burton, supra note 7, at 387.}
\end{itemize}
and the objective standard apparently limited to the sales articles, and expresses the hope that the objective standard will be adopted as the general standard.\textsuperscript{25} Good faith performance, he notes, "properly requires some objective standard tied to commercial reasonableness."\textsuperscript{26} Summers, consistent with his views on the nature of good faith, argues that a purely objective standard is critical to give good faith meaning.\textsuperscript{27} Professor Gilmore, in a frequently cited passage discussing good faith in the context of acceleration clauses, notes that "[t]he creditor has the right to accelerate if under all the circumstances . . . a reasonable man would have done so."\textsuperscript{28} On the other extreme is the legislative intent argument. In Professor Braucher's view the standard is subjective since the history of the Code and its revisions show the intention to adopt a subjective standard.\textsuperscript{29}

These statutes and commentaries form the backdrop of the good faith theories of lender liability. They are the sources from which courts and litigants will draw in future lender liability litigation. Although varied, the attempts to define good faith and the standard by which it is judged reflect the underlying idea that good faith protects contracting parties' expectations.\textsuperscript{30} This is the core of the theory. The cases, both those expanding the theory and those limiting it, frequently stray from this central premise. Yet only adherence to the true focus of good faith—expectations—can guarantee an effective and meaningful remedy for bad faith in lending contracts.

\section*{The Line of Credit Cases and the Scope of Good Faith}

The distinguishing characteristic of the recent wave of borrower litigation has been the willingness of courts to expand theories of law to find the lender liable.\textsuperscript{31} Nowhere has this been made more clear than in the good faith cases. For example, good faith theories recently have been applied to every stage of the lending relationship, from negotiation

\begin{itemize}
\item \textsuperscript{25} Farnsworth, supra note 11, at 673-74.
\item \textsuperscript{26} Id. at 671.
\item \textsuperscript{27} Summers, supra note 20, at 205, 214.
\item \textsuperscript{28} 2 G. Gilmore, Security Interests in Personal Property § 43.4, at 1197 (1965).
\item \textsuperscript{29} Braucher, The Legislative History of the Uniform Commercial Code, 58 Colum. L. Rev. 798 (1958) ("[N]egligence [is] irrelevant to good faith." Id. at 812). Another view minimizes the significance of the choice, suggesting that similar outcomes are reached in either case. See I W. Hawkland, Uniform Commercial Code Series § 1-208:01, at 207 (1982); White & Summers, The Uniform Commercial Code § 26-3, at 1088 (1980).
\item \textsuperscript{30} Burton, supra note 7 at 371.; Burton, Good Faith Performance of a Contract within Article 2 of the Uniform Commercial Code, 67 Iowa L. Rev. 1 (1981); Farnsworth, supra note 11, at 669.
\item \textsuperscript{31} Ebke & Griffin, supra note 5.
\end{itemize}
of the loan\textsuperscript{32} to the retaking of collateral.\textsuperscript{33} Some cases invoke good faith to reverse previously settled rules.\textsuperscript{34} The most significant expansion of good faith has come in the line of credit cases.

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 hope of resuscitation may be an influx of cash, which is precisely the function of the credit line. Yet the lender is quite naturally concerned with throwing good money after bad. In recent cases courts applied the good faith provisions of the U.C.C. to this conflict, and several times held the lender liable for termination of the credit line.

The traditional view taken by courts is that a line of credit does not obligate the lender to fund every request unless specifically provided for in the contract. For example, in \textit{Midlantic National Bank v. Commonwealth General},\textsuperscript{35} the lender refused to advance on the borrower corporation’s $400 million line of credit after one of its subsidiaries filed for bankruptcy. The court contrasted the line of credit with the loan commitment, saying, “[A line of credit] does not impart upon the bank the legal responsibility to loan up to the limit . . . but merely facilitates the easier extension of credit.”\textsuperscript{36} Without a showing of another agreement, the lender could terminate the lending arrangement at will, and without notice.

This rule was abruptly challenged in \textit{K.M.C. v. Irving Trust Co.}\textsuperscript{37} The borrower was a mid-size wholesale grocery company and the lender

\textsuperscript{32} See, e.g., 999 v. CIT Corp., 776 F.2d 866 (9th Cir. 1985).
\textsuperscript{34} See, e.g., Brown v. Avemco, 603 F.2d 1367 (9th Cir. 1979). The law seemed settled that the good faith provision of § 1-208 did not apply where the borrower was in breach of the loan agreement. See, e.g., Anderson, Uniform Commercial Code, § 1-208:5, at 441 (3d ed. 1981); 1 W. Hawkland, Uniform Commercial Code Series, § 1-208:01, at 205 (1982). Nevertheless, the Brown court imposed the good faith limitation although the borrower violated the loan agreement by leasing the secured property without consent. The court held that even in the event of a technical breach, the lender must exercise good faith.
\textsuperscript{35} 386 So. 2d 31 (Fla. App. 3d Dist. 1980); see also Grandin Indus., Inc. v. Florida Nat’l Bank, 267 So. 2d 26 (Fla. App. 4th Dist. 1972).
\textsuperscript{36} \textit{Midlantic National Bank}, 386 So. 2d at 33.
\textsuperscript{37} 757 F.2d 752 (6th Cir. 1985).
a New York bank. The business of wholesale grocering requires immense amounts of capital; accordingly, the plaintiff established a large credit line with the defendant. The lending arrangement required that all of K.M.C.'s accounts receivable be deposited in a "blocked account" over which Irving had complete control. Those deposits were then immediately credited against K.M.C.'s loan balance. As a result of this arrangement, K.M.C. depended entirely upon Irving for operating capital.

Three years into the lending arrangement, K.M.C. made a fairly routine request for an advance on the credit line. The amount requested would have brought the balance on the line to its limit. Irving's loan officer, Sarokin, refused to advance the funds. With no capital available to continue its business, K.M.C. began to collapse. Three days after his initial refusal, Sarokin agreed to lend almost the full amount earlier requested. However, the consent came too late, and K.M.C. liquidated.

At the time of the refusal, Irving was fully secured, holding an interest in all K.M.C.'s accounts receivable and its highly liquid inventory. The quarterly audits of K.M.C. showed that the lender would suffer no loss in the event of liquidation, as it could recoup the entire indebtedness by selling the inventory and collecting the accounts receivable.

The Sixth Circuit held that good faith required the lender to give notice to K.M.C. sufficient to allow it an opportunity to obtain alternative financing or a buyer. Only if Irving could come forward with a "valid business reason," by which the court apparently meant some belief of insecurity, could it avoid liability. Irving had the power over the continued existence of K.M.C. No reasonable party would place itself in that situation unless it expected good faith, which in this case meant reasonable notice. The reasonable notice requirement came into good faith by analogy to section 2-309, a sales article which requires

38. Id. at 754.
39. Id. at 759.
40. Id.
41. Id. at 762.
42. Id. at 754.
43. Id. at 763.
44. Id. at 754.
45. Id. at 762.
46. Id. at 762.
47. Id. at 763.
48. Id. The plaintiff's argument had been made before in Sahada v. Continental Ill. Nat'l Bank & Trust, 706 F.2d 193 (7th Cir. 1983). The Seventh Circuit noted but sidestepped the issue, deciding the case on other grounds.
49. K.M.C., 757 F.2d at 763.
50. Id.
reasonable notice before terminating certain long-standing relationships between buyer and seller.51

Before K.M.C., it had been thought that the lender had complete discretion over whether or not to advance funds on a line of credit. The decision startled the lending community. The courts, too, quickly responded to the decision, as several borrowers in litigation brought it to their attention.

In Shaughnessy v. Mark Twain State Bank,52 the borrower had a line of credit to develop real estate. Winter weather conditions halted construction, and he informed the lender of his intention to renew the project in the spring.53 When he did, the lender refused to advance any funds.54 The borrower alleged bad faith on the part of the lender in cutting off the credit line without notice.55 The Missouri court chose to distinguish the situation from that in K.M.C. Shaughnessey's credit line did not involve a blocked account, therefore his alternate sources of capital left him more protected than the K.M.C. debtor.56 Given that, he could not claim that failure to give him notice of the termination constituted bad faith.57

A Florida court also took issue with the K.M.C. decision. In Flagship National Bank v. Gray Distribution Systems,58 a line of credit for $400,000 was extended to a large distributor as part of a debt workout plan.59 This plan involved a lock box arrangement, one almost identical that in K.M.C.60 Gray had no source of capital apart from the line. The lender terminated the line of credit, and the borrower, unable to purchase in large quantities, soon collapsed.61 The borrower then sued the lender, citing K.M.C. The Florida court affirmed the earlier decisions which held that a lender was not obligated to fund a line of credit.62 Nonetheless, the court went on to distinguish K.M.C. on several grounds. Gray was over his credit limit, and the lender had given some form of

51. Id. at 759.
52. 715 S.W.2d 944 (Mo. App. 1986).
53. Id. at 946.
54. Id.
55. Id. at 953.
56. Id.
57. Id.
58. 485 So. 2d 1336 (Fla. 3rd Dist. Ct. App. 1986).
59. Id. at 1338.
60. The lender had Gray on an even tighter string than K.M.C. had been. The lender controlled not only all influxes of capital, but also the checking account. The borrower had to get preapproval of its budgets from the lender. Id.
61. Id. at 1339.
62. Id. at 1340.
Moreover, the course of dealing between Flagship and Gray was much shorter. It appeared that K.M.C. would be read narrowly, headed for death by distinction, when the U.S. First Circuit Court of Appeals joined the K.M.C. court's position in Reid v. Key Bank of Southern Maine. Reid, a small painting subcontractor, maintained a credit line at Key Bank for several years. Facing a large job, he arranged with the lender for an extension of his credit limits to $25,000. To secure the loan, Reid assigned all his accounts receivable to the lender. Apparently, the assignment included a provision that all checks for Reid's work were to be made out to the lender. Two months after the new agreement, the lender telephoned Reid to inform him that the Bank would advance no further funds on his credit line. For four months, the two parties did not communicate with one another. During that time, the Bank credited about one-third of a check sent to it against Reid's loan balance. Reid failed to make the interest payments on the outstanding balance, and, after Reid failed to respond to overdue notices, Key Bank repossessed the collateral. Reid filed for bankruptcy, and then filed suit against the lender for terminating his credit in bad faith. He based his claim on breach of the good faith duty, partially on grounds of improper racial motivations. The jury held the lender liable for bad faith in its dealings with Reid.

The First Circuit upheld that verdict. The court first noted that there was a right of action in contract based on good faith. As the jury had been properly instructed, the only other question on appeal was the sufficiency of the evidence. Citing a laundry list of evidentiary combinations which could have led to a finding of bad faith, the court

63. Id. at 1341. This is problematical, for the "notice" given was a refusal to lend any more funds until the balance declined (through collection of accounts receivable). It is questionable whether this was the form of notice contemplated in KMC.
64. Id.
65. 821 F.2d 9 (1st Cir. 1987). The citation of § 1-208 also rendered the KMC holding "suspect" in the Flagship court's view. See infra notes 79 to 104.
66. Id. at 11.
67. Id.
68. Id.
69. Id.
70. Id.
71. Id.
72. Id. at 11-12.
73. Id. at 11.
74. Id. at 12.
75. Id. at 15.
76. Id. The court listed the following findings which the jury could have made: that
decided that there was enough evidence to support the jury finding. All of the evidentiary factors were unclear, but three findings appeared critical: the lender’s termination of the relationship shortly after approving the borrower for higher credit limits; the existence of possible racial motivations; and the lender’s failure to explore an alternative to closing the credit line.\textsuperscript{77}

The line of credit cases present a rather confused state of affairs. On the one side, courts are steadfastly refusing to give any real meaning to good faith as a limitation on termination of a credit line. But it is not implausible, and may be quite proper, to impose some limitation. The line of credit vests enormous discretion in the lender, and the exercise of this discretion could devastate financially the borrower who is dependent upon the line to any significant degree. Where there is a long relationship between borrower and lender, certain expectations arise, and these should at least be examined by courts. The line of credit extension presents the very sort of situation to which the good faith limitation was meant to apply.

The \textit{K.M.C.} court, on the other hand, broadly expanded the notion of good faith to include reasonable notice, analogizing to the notice provisions in the sales articles. If good faith could include reasonable notice provisions formerly confined to the sales articles, what else might it include? That approach presents an alarming danger to the lender in the name of protecting the borrower. Good faith protects expectations, but both parties have legitimate expectations. Swift changes in the law and broad impositions of new duties in the name of good faith could impinge on the lender’s idea of the terms of the arrangement. Despite this expansive and unexpected reading of good faith by the Sixth Circuit, \textit{K.M.C.} did provide guidelines to future lenders. No matter how justified the criticism of the rule, it is at least a rule. As shall be seen shortly, not all courts have been so forthcoming.

In one sense the \textit{Reid} decision is more satisfying than \textit{K.M.C.} The borrower in \textit{Reid} was a small, unsophisticated player in a very complex

---

\textsuperscript{77} Id. at 15-16.
game, not a large, powerful (and represented) business entity. Perhaps it was proper to allow the jury greater flexibility in protecting the expectations of such a borrower. However, the case is wholly unjustifiable in another, much more important, aspect. The court does not isolate any improper conduct by the lender, but rather gives a grabbag of actions that might have constituted bad faith. This list is far too broad to offer guidance. That is the type of decision which lenders most fear. The Reid court utterly fails to alert lenders to what will be expected of them, and in that sense represents the very worst application of the good faith theories.

Courts and lenders can draw some lessons from the line-of-credit cases. Lenders know that they must be cautious when entering long-term credit line arrangements, and that it is dangerous to allow the borrower to rely solely on the credit line for its capital. But beyond this there is no more specific guidance. Courts addressing a borrower’s claim of bad faith can glean the proper approach from these cases, though mostly by way of counter example.

Good faith is an appropriate limitation on the lender, but it must be applied with care. To enlarge its scope suddenly and without explanation is imprudent and dangerous, as is finding liability without articulating the objectionable conduct or any rationale. Above all, courts must learn to focus on the real issue: what has the lender done under the agreement which violated the reasonable expectations of the other parties? Protecting expectations is the purpose of imposing good faith limitations in the first instance; therefore, courts must keep them foremost in mind when applying good faith.

**The Demand Note Exception**

Another important category of cases deals with demand notes. Courts faced with difficult questions of the lender’s responsibility sometime seek refuge in the “demand note” exception. This exception grew up around the comment to section 1-208, which reads:

> Obviously this section [limiting the exercise of acceleration clauses to those made in good faith] 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.\(^78\)

Several cases seized upon this language to create an exception to the good faith obligation where the lending documents contained demand

---

\(^{78}\) U.C.C. § 1-208 official comment.
language. Such cases hold that no matter how questionable the lender's conduct, there will be no inquiry into good faith if the indebtedness was due on demand.

A good example of the application of this doctrine is in *Fulton National Bank v. Willis-Denney Ford, Inc.*79 This case involved an inventory financing arrangement between a car dealer and its bank. The bank paid the factory invoices when new automobiles were shipped to the dealer, and the dealer then executed a demand note in the bank's favor.80 The bank decided to call the notes it held when it discovered numerous irregularities in the dealer's operation and when the dealer proved uncooperative in correcting them.81 The dealer obtained other financing and sued the lender for breach of the obligation of good faith under section 1-208 and section 1-203.82

The sole issue for the Georgia appeals court was whether the obligation of good faith applied to a demand instrument. Looking to the legislative history and the comment to section 1-208, the court held that it did not apply.83 As to the dealer's argument that the general obligation of good faith must apply under section 1-203, the court curtly responded: "[T]he only duty under the U.C.C. on a holder of a demand instrument is to seek enforcement of [it] within the applicable statute of limitations."84

That notion has been followed in more recent lender liability cases. In *Centerre Bank v. Distributors, Inc.*,85 the court also refused to consider evidence of bad faith in the context of a demand note, but on entirely different facts. The defendant-borrower was a distributing corporation which purchased all of its inventory under a financing arrangement with its bank.86 The loan was set up under a promissory note, due on demand, with additional terms contained in a lending agreement.87 The owner had personally guaranteed the note.88 Brown, a manager for defendant Distributors, wished to buy the business. The highly leveraged business could not operate without financing, so quite naturally Brown inquired into the continued financing of the business.89 The loan officer informed

---

80. Id. at 916-17.
81. Id.
82. Id. at 918.
83. Id.
84. Id.
85. 705 S.W.2d 42 (Mo. App. 1985).
86. Id. at 45.
87. Id. at 44.
88. Id.
89. Id. at 45.
him that while the transaction must obtain the approval of the loan committee, there would be no difficulty, for the guarantor (seller) was sufficiently wealthy.\(^9\)

Brown bought the business and at the bank's request delivered his personal guaranty on the note.\(^1\) Three days after that, the bank notified him of its intention to call in the note.\(^2\) The bank extended the deadline several times and agreed to a voluntary liquidation plan (which was not instituted), but eventually repossessed the collateral and brought suit for the deficiency.\(^3\) Brown's claims of bad faith went unheeded. This was a demand note, said the court, and limiting the call of the note by good faith would "add an additional term the parties did not agree to."\(^4\)

More recent cases refuse to end the inquiry at the first hint of demand language. The \(K.M.C.\) court expressed a willingness to apply a good faith obligation to all demand paper.\(^5\) The lender had argued that the demand language in the loan agreement eliminated any requirements which good faith might impose upon calling in the loan. The court rejoined:

"Just as Irving's discretion whether or not to advance funds is limited by an obligation of good faith performance, so too would its power to demand payment. The demand provision is a kind of acceleration clause, upon which the Uniform Commercial Code and the courts have imposed a limitation of reasonableness and fairness."\(^6\)

Other courts facing demand note arguments have chosen another route: they simply refuse to characterize the lending agreement as a demand instrument. In \(Shaughnessy\), for example, the Missouri court faced a loan arrangement very similar to the one in \(Centerre.\)\(^7\) This court found that the terms of other parts of the agreement were inconsistent with the demand language and that therefore good faith applied.\(^8\)

The \(Reid\) court, addressing similar demand language, refused to find a demand instrument which precluded good faith considerations.\(^9\) The

\(^9\) Id.
\(^1\) Id.
\(^2\) Id.
\(^3\) Id. at \(46.\)
\(^4\) Id. at \(48.\)
\(^5\) 757 F.2d at \(760\) (1986).
\(^6\) Id.
\(^7\) \(Shaughnessy,\) 715 S.W.2d at \(946.\)
\(^8\) Id. at \(950.\)
\(^9\) 821 F.2d at \(13-14\)
The court stated that the note in question was given along with a number of other documents to form a line of credit. The lender could not have enforced the note against Reid for its face value, for that amount had not been lent. Therefore, the demand language could not "represent the beginning and the end of the inquiry into the time term of the contract." Other loan documents contained default provisions, and oral testimony indicated that the repayment schedule was set by oral agreement. All of this countered the assertion of the bank, and good faith could be considered.

Rigid adherence to the so-called demand note exception obfuscates the true concerns. Rather than focusing on the exception, courts should attempt to determine whether the expectations of the party were tread upon by an exercise of discretion. Indeed, some courts have already shifted their inquiry, such as in those cases more closely scrutinizing the language in the lending agreements. This leaves the substance of the demand note exception intact, for when the parties truly frame their transaction in demand form there can be no expectation of a limitation on its collection. At the same time, this approach would leave the courts free to inquire into the lender’s conduct, eliminating the cases in which highly questionable conduct on the part of the lender goes unpolic ed by the courts. Courts would also be free to inquire into the relative sophistication of the parties, something that has been notably lacking in the demand note cases.

The Standard of Good Faith

Another line of cases shows that the disagreements among scholars and commentators as to the proper standard of good faith has spilled over into the courts. Many cases apply, at least nominally, the subjective standard. A good case in point is Van Horn v. Van der Wol, Inc. When the creditor learned of a rumor that the borrower had been denied a loan application, he accelerated the notes he held. The loan had not, in fact, been denied. The borrower defended the suit

100. Id.
101. Id. at 14.
102. Id.
103. Id.
104. See supra notes 26 to 29.
106. 6 Wash. App. 959, 497 P.2d 252 (1972); see also Annot., 61 A.L.R. 3d 244 (1975).
107. Id. at 253.
108. Id.
on the notes by a claim of bad faith, claiming that the lender could not reasonably have been insecure, and therefore could not have been in good faith. The court disagreed: "The standard is what [the lender] actually knew, or believed he knew, not what he could or should have known. Because [the lender] believed [the borrower] had been denied a loan, and acted in accordance with that belief, he acted in good faith."

The rule did not stand in some later lender liability cases. In Black v. Peoples Bank and Trust, the Mississippi Supreme Court faced the issue of the standard. The court noted the criticisms of the objective standard in the case law and cited Gilmore's comments. It then resorted to pre-Code law and applied an objective standard. Likewise, the K.M.C. court made it clear that there must be some objective component. Even if the loan officer in question had actually believed that his decision to close the line was justified, the lender's conduct must "to some extent . . . be measured by objective standards." In Reid, the Sixth Circuit interpreted the trend in Maine case law as sharply toward an objective standard.

Which test is best in the lender liability case? As the scope of good faith expands, the courts will have to face that question. Proper analysis will require consideration of the distinction between good faith performance and good faith purchase. The standard for the first will not necessarily be applied to the second. If courts addressing lender liability cases are going to confront good faith, those courts must decide which of the standards adequately protects the lenders' and borrowers' expectations. There are three possibilities: a purely subjective test; a purely objective test; or some combination of the two.

A purely subjective test would be the most advantageous to the lender. To recover, the borrower would have to prove a dishonest state of mind. Aside from the difficulties in proving intent, there is the problem of risk. The borrower is subjected to his lender's risk aversity, a factor which he can not control. The borrower is forced to behave in a way which will not alarm his lender. Though an equity holder (owner), the borrower is limited by the risk a fixed-interest holder (lender) would take.

109. Id.
110. Id. at 254.
111. 437 So. 2d 26 (Miss. 1983).
112. Id. at 29.
113. Id.
114. 757 F.2d at 761.
115. Id.
116. 821 F.2d 9, 14.
117. See supra notes 17 to 19.
The purely objective test is little better. In an unstable industry, with a diverse group of lenders, a reasonable standard may be difficult to ascertain. Furthermore, the situations in which the lenders operate may require more leeway. For example, a lender faced with a borrower going insolvent must decide whether to enforce his security or risk loss of the amounts loaned; and the lender must do it quickly, for under state collection law, "first in time is first in right." Within this environment, it might be unrealistic to hold lenders to an objective standard. Furthermore, as the cases have shown, there is a potential for overexpansion of the doctrine of good faith so as to invade the expectations of the lender, which a floating objective standard could exacerbate.

The better approach would be to base the standard primarily on the subjective beliefs of the lender, but create an objective limitation. This seems to be the approach the K.M.C. court indicated. The lender will be given latitude in his decisions, but some claims are simply outside the scope of permissible lending behavior. Put another way, certain actions of the lender, such as foreclosing when fully secured and when the borrower was not in default, invade too far the expectations of the borrower.

**The Tort of Bad Faith in Lender Liability**

There is some possibility that a tort of bad faith will emerge in the lender liability cases. Tort liability for breach of the implied obligation of good faith began as a response to abuses in the insurer-insured relationship. The tort was based on a twofold rationale, that the insurer and the insured enjoyed a "special relationship," and that contract damages both undercompensated victims of insurer abuse and undeterred the insurers.

---

118. This would become important, for example, where a lender bank sought to exercise its right of setoff. See, e.g., Karner v. Willis, 238 Kan. 246, 710 P.2d 21 (1985).
119. 757 F.2d 752, 761.
120. White and Summers, supra note 31, suggest this form of an objective test in judging the propriety of acceleration. It requires no great leap to apply it to all good faith claims in lending transactions.
122. Comment, Punitive Damages, supra note 121, at 336; Lempert, California's Other Lottery: Tort Actions on the Implied Covenant of Good Faith and Fair Dealing, 7
The special relationship rationale has formed the basis for the spread of the bad faith tort doctrine from insurance contracts to other types of contracts. Only a few cases address the possible application of the tort of bad faith to lending contracts. In Wagner v. Benson, a California court was willing to assume that breach of good faith in a lending contract constituted a tort, but found no breach. The lender in that case had financed an investment for the borrowers. When the investment began to fail, the borrowers sued the lender, claiming that it had a tort duty to disclose the risks in the venture. Even if such a tort existed, held the Wagner court, the lender's conduct was well within the social norms imposed by tort law.

The only reported case basing lender liability on the bad faith tort, First National Bank v. Twombly, was a relatively ordinary lender liability case. The borrower had signed a promissory note calling for one lump sum payment in the middle of August. However, the lease on the borrower's restaurant expired at the end of July, and negotiations to renew had failed. The borrower, contacting the loan officer, secured an agreement to convert the note to an installment loan. However, the loan officer was going out of town, and the borrower was to complete the arrangements with the lender's vice-president, whom the loan officer was to inform of the deal.

The vice-president, however, claimed to know nothing of the deal when Twombly called. As Twombly was unemployed, the vice-president adamantly refused to convert the loan, and he insisted that the full amount be paid then. Although the note was not due for another


126. Id. at 519.
127. Id. at 520, 521.
128. Id. at 521.
129. 689 P.2d 1226 (Mont. 1984).
130. Id. at 1228.
131. Id.
132. Id.
133. Id.
134. Id.
135. Id.
two weeks, the vice-president decided to accelerate the loan and to offset Twombly's checking account. He based his decision only on what Twombly had said and made no further investigation.

The Twombly court recognized the general rule that the good faith obligation only gave rise to contractual remedies. But where, as here, the duty "was imposed as a matter of law," the court stated rather enigmatically, tort liability would result. The court cited for this proposition an employment case involving wrongful discharge of an at-will employee, a case which itself relied on prior insurance bad faith cases. It is unclear what the court meant, but perhaps implicitly it recognized a special relationship between bank and customer analogous to that between insurer and insured.

More recent cases reject the tort theories. In Rigby Corp. v. Boatmen's Bank and Trust Co., a Missouri court held that the U.C.C. good faith obligations were contractual, and did not give a cause of action in tort. The Eighth Circuit, ruling under Arizona law, faced the same question in Betterton v. First Interstate Bank. Noting that the Arizona Supreme Court had refused to extend the bad faith tort from insurance to employment contracts, it predicted that it similarly would refuse to extend it to lending contracts. The borrower would be left to contractual remedies alone.

In applying the special relationship rationale to lenders, courts would only do in a roundabout way what they could do more cleanly under the contract theories. The special relationship could be found only where certain expectations had built up. Yet rather than focusing on these expectations and protecting them between the parties, the court would be forced, in order to justify application of the tort, to focus on the relative positions of the parties. This would protect not their expectations, but only those of parties similarly situated. Clearly the positions of the parties would be relevant to what they expected, but it would not be the ultimate consideration, and focusing exclusively on that factor would lead to neglect of many other factors which bear upon the parties' expectations. Thus, applying the tort rationale would be much less effective in protecting the parties.

The practical significance of the theoretical difference between tort and contract, the availability of larger damage awards, could justify the

136. Id. at 1229.
137. Id. at 1230.
139. 713 S.W.2d 517 (Mo. App. 1986).
140. Referring to U.C.C. § 1-203 and § 1-208.
141. 800 F.2d 732 (8th Cir. 1986).
142. Id. at 736.
application of tort theory if greater damages were necessary to protect borrowers. The awards in lender liability cases, however, show fairly convincingly that lack of damages will be no disincentive to sue on lending contracts, as it may have been in the insurance contracts. Moreover, as has been often noted, the expansion of damages in contract, rather than the recognition of a new cause of action, is the better response to the problem if it is found to exist.

Use of the tort theory could have a subtle effect on lender liability cases proceeding under good faith: it might distract the court from inquiry into the expectations of the parties while directing it toward the relative positions of the parties. The tort theories could offer greater damages to the borrower, but even if the expanded damages were necessary, the same end could be as easily achieved using the more traditional theory of good faith—contract. Left with a rationale unsuited to the lender-borrower context, courts would be hard pressed to give any real meaning to good faith.

CONCLUSION

Good faith centers on expectations, but courts addressing good faith in the lender liability cases have frequently lost sight of this basic proposition. This has caused some courts to fail to recognize the utility of good faith in policing contractual behavior, while others have proceeded to recognize new and broader good faith obligations without adequate articulation of their rationale. The line-of-credit cases are an excellent example of the confusion that results when courts attempt to apply an obligation without recognizing its theoretical basis. The demand note cases also reflect this tendency, with some courts obstinately refusing to go past the wooden exception no matter what the circumstances. Only a few cases have gone further and attempted an expectation inquiry, usually by scrutinizing the language and circumstances of the agreement. Likewise, courts have struggled over which standard to use in judging good faith without discussing which will best preserve expectations. Examining the problem in terms of expectations leads to the conclusion that a primarily subjective standard with a broad, objective limitation best satisfies this purpose. Finally, the judicial discussion of the propriety of the tort over the contract theories of good faith avoids the true concern, protecting the parties' expectations. As the tort rationale does not fit lending cases well, and leads courts even further from the primary inquiry, it should be rejected. If courts are willing to confront the task

143. See cases cited supra note 2.
144. See Comment, Punitive Damages, supra note 119, at 357; Comment, Tort Remedies, supra note 121, at 402.
of developing expectation-consistent theories of good faith, those theories of lender liability might prove beneficial. If they merely avoid the difficult questions, as some have done, then good faith theories become dangerous traps for lenders, and therefore fail entirely in their function.

Paul Matthew Jones