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Lender Liability: Changing or Enforcing the Ground Rules?

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LENDER LIABILITY: CHANGING OR ENFORCING THE GROUND RULES?

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INTRODUCTION

The debtor-creditor relationship is grounded on the agreement of the parties and supplemented by the state law of contracts. According to the traditional understanding, this leaves the parties largely in control of their own destiny. The terms and conditions of the agreement establish and circumscribe the rights and obligations of the parties. At the center of the relationship is the exchange of money or credit for the promise to repay. In the great majority of these relationships, performance is accomplished by voluntary action of the parties.

The relationship is not governed solely by the private consensual agreement of the parties. State law most often supplements the relationship when the debtor fails to perform as promised. The creditor's resort to the remedies afforded by state law is intended to provide a substitute, albeit an imperfect one, for the voluntary performance by the debtor. On the other hand, the debtor may resort to a restructuring or discharge of the obligation under the protection of the federal bankruptcy laws, as an alternative to voluntary performance or involuntary performance under compulsion of state law.

The focus of the law has traditionally been on the performance by the debtor. State law gives the creditor enforcement remedies when the debtor defaults.[1] Enforcement may be tempered by the protection of certain exempt property under state law.[2] Federal bankruptcy law may excuse or modify the debtor's performance. Recently, however, the performance of the creditor has come under scrutiny by the courts. Whereas the obligation of the creditor had formerly been regarded as completed when the money or credit was extended, it is now recognized that the creditor has continuing obligations throughout the term of the relationship. The importance of the debtor's obligation to perform has not been diminished. But the creditor's just demand for payment

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1. *See, e.g.*, S.D. CODIFIED LAWS ANN. Ch. 15-16 (1984) (judgments); S.D. CODIFIED LAWS ANN. Ch. 15-18 (1984) (execution of judgments); S.D. CODIFIED LAWS ANN. Ch. 15-19 (1984) (execution sales); S.D. CODIFIED LAWS ANN. Ch. 15-20 (1984) (proceedings supplementary to execution); S.D. CODIFIED LAWS ANN. Ch. 21-15 (1987) (claim and delivery of personal property); S.D. CODIFIED LAWS ANN. Ch. 21-17A (1987) (attachment of property); S.D. CODIFIED LAWS ANN. Ch. 21-18 (1987) (garnishment of debts and property).

2. *See generally* S.D. CODIFIED LAWS ANN. Ch. 43-31 (1983) (homestead exemption); S.D. CODIFIED LAWS ANN. Ch. 43-45 (1987 Supp.) (homestead and personal property exemptions).

will no longer excuse its failure to keep promises or to abide by the duty of good faith and fair dealing.

Consider, for example, the following facts from *Yankton Production Credit Association v. Larsen.*[3] The debtors owned and operated a large farm in Knox County, Nebraska. In order to expand their livestock breeding operation, they sought financing from the PCA in 1978. Their request for a total line of credit of $821,982.37 was approved by the PCA. The money was to be released as the debtors needed it. The security agreement, however, provided that the PCA retained "absolute discretion" over whether it would make any future advances to the debtors.[4] In 1980, the debtors executed a note in the amount of $737,000, which was intended to be allocated in the amount of $570,000 for the purchase of livestock and $167,000 for operating expenses. The PCA provided only $251,382 for the purchase of livestock. As a result, the debtors "could not buy the livestock needed to fully utilize their expanded operation and generate the necessary profits to make the payments on their debt."[5] The next year, the PCA initially agreed to loan $362,825 to the debtors, but ultimately released only $154,975 of funds. The PCA also agreed to loan $10,000 later the same year, but again advanced only $4,473 to the debtors.

Later, the debtors defaulted on the notes and suit was brought by the PCA. The parties stipulated to judgment on the PCA's claim. The debtors filed a counterclaim, however, claiming that the failure to advance the remainder of the agreed-upon loan amounts cost them $650,000 in lost profits. Their counterclaim was based on breach of an express and implied commitment to provide the debtors with a continuing line of credit to finance the expansion of their operation and upon breach of the duty to deal in good faith. The PCA asserted in response that it had no contractual obligation to loan a specific amount of money and that any advances were to be at the sole discretion of the PCA. The trial court granted summary judgment in favor of the PCA.[6]

On appeal, the Supreme Court of Nebraska found genuine issues of material fact and reversed the granting of summary judgment. First, there was a factual dispute over whether the PCA had agreed to finance the expansion of the debtors' operation and, if it had, whether the debtors relied on this promise to their detriment. The trial court had concluded that the loan documents reserved the right of the PCA to decide whether to advance funds. There was other evidence, however, which supported the debtors' contention that the PCA had expressly agreed to provide a continuing line of credit for expansion of the livestock operation, including financing for livestock inventory.[7] In reliance upon this promise, the debtors made capital improvements to the feeding

3. 219 Neb. 610, 365 N.W.2d 430 (1985).
4. *Id.* at —, 365 N.W.2d at 432.
5. *Id.* at —, 354 N.W.2d at 432.
6. *Id.* at —, 365 N.W.2d at 431.
7. This, of course, presents the familiar conflict between the written documents and oral statements made in connection with the loan. This conflict is discussed in the text accompanying notes 29-45, *infra*.

operation and the feed storage facilities. The supreme court concluded that the debtors had presented a credible argument for promissory estoppel. "By financing the Larsens' expansion and then cutting off the funds necessary to buy livestock to utilize the expanded facility, the PCA contributed to the financial difficulties that the Larsens later encountered."[8]

In addition, there was a factual issue as to whether the PCA acted in good faith when it declined to advance funds up to the amount of the budgeted loan. The supreme court cited section 1-203 of the Uniform Commercial Code which imposes an obligation of good faith in the performance and enforcement of every contract.[9] In light of this general obligation imposed by law, there was a factual issue of whether the refusal of further advances was based on a good faith business judgment or whether the refusal breached the obligation of good faith. Accordingly, summary judgment was not appropriate on this ground as well.

The *Larsen* case is an example of the increasing attention paid to the performance of the creditor during the course of the debtor-creditor relationship. Default by the debtor does not excuse failure of the creditor to perform its obligations. In fact, there is some willingness to consider the creditor's breach in some instances as a cause of the debtor's default. In any event, the obligations of both debtor and creditor are increasingly being viewed as integrally related, rather than as mutually exclusive.[10] Moreover, examination of the creditor's performance has not been limited to contract doctrine. Tort doctrines relating to fraud and misrepresentation, analogies to fiduciary obligations, and statutory remedies are also being utilized by the courts to measure the creditor's actions. These additional theories carry with them a greater range of remedial relief, including the possibility of punitive damages.

It is probably the enhanced damages in recent lender liability cases which has attracted the most publicity. A jury in Monterey County, California, recently awarded $10 million in compensatory damages and $50 million in punitive damages to a farmer whose strawberry operation had been closed down by Wells Fargo Bank.[11] Another judgment in Sonoma County, California, amounted to $46.695 million, based on unfair dealings with a debtor in the apple processing business.[12] A federal jury in Florida has awarded compensatory damages totalling $105 million to a real estate developer whose line of credit had been withdrawn by Continental Illinois National Bank.[13] The stun-

8. 219 Neb. at —, 365 N.W.2d at 433.
9. *Id.* at —, 365 N.W.2d at 434.
10. This corresponds generally with a shift in general contracts doctrine which downplays the importance of the traditional unilateral and bilateral contracts labels. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981) (Reporter's Notes to Comment f). If one were to use the traditional labels, it would be fair to say that the debtor-creditor relationship is less often viewed as having become unilateral by full performance by the creditor and more often viewed as bilateral or executory with significant obligations remaining on both sides during the entire course of the relationship.
11. Conlan v. Wells Fargo Bank, Monterey Superior Court No. 82852.
12. Kruse & Jewell v. Bank of America, Sonoma Superior Court No. 112439, *rev'd* 201 Cal. App. 3d 354, 248 Cal. Rptr. 217 (1988).
13. FDIC v. Scharenberg v. Continental Illinois Nat'l Bank, No. 84-2712-Civ-Davis; No. 97-0211-Civ-Davis (S.D. Fla. 1987).

ning size of these awards has generated intense interest in the lender liability area by both creditors and debtors.[14]

This article will survey the various theories which have been asserted by debtors as a defense in a collection or foreclosure action or as a ground of lender liability. In some instances, the courts have done no more than apply well-established doctrines to the debtor-creditor relationship. In addition to contract doctrine, the courts have looked to tort doctrine and other theories arising in related contexts. Debtors have also found relief in certain federal statutes not originally intended for application to the debtor-creditor context, but which have proven useful in lender liability cases. These statutes, primarily RICO[15] and section 1983 actions for deprivation of constitutional rights under color of state law,[16] have provided debtors with theories to put the creditor on the defensive, even when money is clearly due and owing to the creditor.

The intention with respect to this survey is to collect the cases and provide a roadmap for parties and counsel. The primary purpose is descriptive. It is not intended to be an advocacy piece for any side. It is this author's opinion that the credit system is essential, that the process is basically fair, and that the cases discussed in this article represent the relatively rare instances of creditor misconduct. The descriptive purpose may help to inform parties about where and how the problems have arisen. To the extent that all parties are aware of what is "out there," it is hoped that some of the more unfortunate cases will avoid repetition.

CONTRACT CLAIMS AND DEFENSES

Contract Claims Based on Breach of Promise

Because the debtor-creditor relationship is grounded on agreement of the parties, it is appropriate to start with consideration of the contract claims and defenses which have been raised by debtors. *Yankton Production Credit Association v. Larsen*[17] illustrates probably the least complex instance of creditor misconduct: the failure to keep a promise. Existing contract doctrine is reasonably well-suited to deal with breach of contract claims asserted by debtors. The claim occurs most often with respect to an alleged commitment to make a

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14. The interest is reflected in the recent scholarly commentary as well. *See, e.g.*, Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775 (1986); Bahls, *Termination of Credit for the Farm or Ranch: Theories of Lender Liability*, 48 MONT. L. REV. 213 (1987); Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUSTON L. REV. 411 (1987); Ellis & Gray, *Lender Liability for Negligently Processing Loan Applications*, 92 DICK. L. REV. 363 (1988); Note, *Letter of Credit Litigation—Bank Liability for Punitive Damages*, 54 FORD. L. REV. 905 (1986); Curtis, *The Fiduciary Controversy: Injection of Fiduciary Principles Into the Bank-Depositor and Bank-Borrower Relationships*, 20 LOY. L.A.L. REV. 795 (1987); Hinerfeld, *Now It's Lenders Who Must Beware*, 7 CAL. LAW. 61 (Sept. 1987); Cappello, *Banking Malpractice?*, 91 CASE & COMMENT 3 (Sept.-Oct. 1986).

15. RACKETEER INFLUENCED AND CORRUPT ORGANIZATIONS ACT (RICO), Pub. Law. 91-452, Title IX, 84 Stat. 941, *as amended*, 18 U.S.C. §§ 1961-1968 (1982).

16. 42 U.S.C. § 1983 (1982).

17. 219 Neb. 610, 365 N.W.2d 430 (1985).

loan or a commitment to refrain from foreclosing on collateral. Allegation of a failure to keep a promise is often sufficient to state a cause of action and to send the case to a jury on even the most straight forward collection or foreclosure action.

In *Larsen*, the parties stipulated that the loan was in default, that the principal sum of $522,290.95, together with interest was due and owing, and stipulated to judgment in favor of the PCA.[18] The chief dispute was over whether there had been a binding commitment by the PCA to lend a greater sum. The debtors claimed that, notwithstanding certain reservations in the loan documents, the PCA had approved a loan for $821,982.37. The debtors made capital improvements in reliance upon the approved credit line, but were unable to fully utilize their facilities when the PCA refused further financing for livestock acquisition. Viewing the evidence most favorable to the debtors, the court found that there existed material issues of fact which could not be resolved by summary judgment.[19] The debtors' claim for lost profits, if accepted by the trier of fact, had the potential to more than offset the judgment in favor of the PCA.

There is nothing unusual about pleading a cause of action on a breach of contract theory. The debtor must allege: (1) the existence of a sufficiently definite contract, formed on the basis of an offer and acceptance and supported by consideration; (2) the facts supporting the allegation of the lender's breach; (3) performance of conditions required of the debtor; and (4) the existence of damages suffered as a consequence.[20]

Accordingly, lenders have been held liable for breach of a promise to provide loan funds to a customer. In *National Farmers Organization v. Kinsley Bank*,[21] the Tenth Circuit upheld a jury finding that the bank had agreed to lend the plaintiffs money for the purchase of lambs. There was a factual dispute over whether the commitment was merely for the down payment or for the entire purchase amount. This dispute was resolved by the jury against the bank. The trial court and the Tenth Circuit also rejected the bank's contention that the commitment was unenforceable because it exceeded the bank's legal loan limit, finding justifiable reliance on the bank's promise by both the buyers and sellers of the lambs.[22]

The existence of an enforceable promise by the lender may preclude the resort to otherwise available remedies in the event of a default. In *Betterton v. First Interstate Bank*,[23] the loan officer on an admittedly delinquent loan met with the debtor to work out the financial problems. The loan was secured with an interest in the debtor's truck, which was in the repair shop at the time

18. *Id.* at —, 365 N.W.2d at 431.
19. *Id.* at —, 365 N.W.2d at 433.
20. *See, e.g.*, Wait v. First Midwest Bank/Danville, 142 Ill. App. 3d 703, —, 491 N.E.2d 795, 799 (Ill. App. 1986) (debtor pleaded a proper cause of action for breach of an oral commitment to loan money for a farming operation).
21. 731 F.2d 1464 (10th Cir. 1984).
22. *Id.* at 1469.
23. 800 F.2d 732 (8th Cir. 1986).

of the meeting. The debtor suggested that the loan could be brought current by assignment of a portion of payments due him in his trucking business directly to the bank. The bank agreed to forego repossession on this basis. However, after the truck had been repaired, it was repossessed the next day on orders from the bank. The Eighth Circuit held that the debtor had stated a valid cause of action for breach of the promise to forego repossession in consideration of the agreement for voluntary garnishment of earnings.[24]

Similarly, in *Baker v. Citizens State Bank of St. Louis Park*,[25] the bank negotiated a restructuring of the debtors' financial obligations, which resulted in the giving of additional security, and soon thereafter called the note due, despite the understanding of the debtors that the bank would forebear from calling the note if the additional security was given. In *Baker*, the bank had just undergone a change in ownership and management when it reviewed the account with Hal Baker Co., a closely-held corporation engaged in the supply and installation of commercial sheet metal roofs. New management decided that unless additional collateral was provided, the notes with the company would be called immediately. They asked for a personal guarantee of the company's indebtedness by the principal owners, to be secured by mortgages on their homestead and certain farm property. The wife refused to sign the mortgage on the homestead, but the husband, under substantial pressure from the bank, signed a mortgage on the farm property, which was held in his name only. The pressure, of course, was that if additional security was not given, the notes would be called. One week after the execution of the mortgage on the farm property, the bank called the notes. The debtors filed suit to declare the second mortgage void. The Minnesota Supreme Court upheld the lower court's decision invalidating the mortgage for lack of sufficient consideration.[26]

The courts thus have not been reluctant to apply traditional contract doctrine to the debtor-creditor relationship.[27] There are some recurring issues, however, which deserve closer examination. The facts in these cases often involve consideration of the creditor's words or actions which the debtor asserts have amounted to some kind of binding commitment on the part of the creditor. The creditor usually responds by pointing to the written instruments as the sole evidence of its undertaking. The effect of the creditor's words and actions will be considered in the next two sections on parol evidence and waiver.

24. *Id.* at 735.
25. 349 N.W.2d 552 (Minn. 1984).
26. *Id.* at 559.
27. *See, e.g.*, First American Commerce Co. v. Washington Mutual Savings Bank, 743 P.2d 1193 (Utah 1987) where the Utah Supreme Court held that a lender remained obligated on a loan commitment after assignment of the loan to another lender with the knowledge and consent of the borrower. Application of traditional contract principles concerning assignment of rights and delegation of duties resulted in a decision in favor of the borrower.

Parol Evidence and the Statute of Frauds

One obstacle usually faced by debtors in connection with a breach of contract claim is the problem of proceeding on the basis of oral statements in the face of written documentation. The principles are familiar, even if their application is not always certain. Parol evidence is generally not admissible to vary or contradict the terms of a written contract.[28] However, parol evidence may be admitted if the written document is incomplete or ambiguous.[29]

In *Baker v. Citizens State Bank of St. Louis Park*,[30] the debtors claimed that the mortgage on personal farm property to secure a corporate debt was given to induce the bank to forebear from calling demand notes. Because the bank subsequently called the notes seven days after the execution of the mortgage, the debtors claimed that the mortgage failed for lack of consideration. The bank asserted that the recital of consideration in the mortgage instrument was conclusive on the issue of adequacy of consideration. The Minnesota Supreme Court held that the recital of consideration in the mortgage instrument was insufficient and thus allowed parol evidence to show the existence of other bargained-for consideration.[31]

In addition to the parol evidence problem, there is now in many states a Statute of Frauds provision relating directly to the extension of credit. In South Dakota, for example, the legislature recently amended its Statute of Frauds provision to read, in pertinent part, as follows:

> The following contracts are not enforceable by action unless the contract or some memorandum thereof is in writing and subscribed by the party to be charged or his agent, as authorized in writing:
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> * * * *
>
> (4) An agreement for a loan of money or for an extension of credit, which agreement may be enforced by a beneficiary for whom the agreement was made, including, but not limited to, vendors of agricultural goods, services or products. . . .[32]

Besides the sometimes generous interpretation of what constitutes a "memorandum,"[33] this provision is also subject to the traditional exceptions, such as part performance or where the elements of estoppel are present.[34] In any event, a debtor faced with the Statute of Frauds problem might consider fram-

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28. *See, e.g.*, Skubal v. Meeker, 279 N.W.2d 23, 27 (Iowa 1979); Dahmes v. Industrial Credit Co., 261 Minn. 26, 35, 110 N.W.2d 484, 490 (1961); Silverman & Silverman v. Arbor Street Partnership, 213 Neb. 628, 631, 330 N.W.2d 904, 906 (1983); Production Credit Ass'n of Fargo v. Foss, 391 N.W.2d 622, 625 (N.D. 1986); Teigen Construction, Inc. v. Pavement Specialists, Inc., 267 N.W.2d 574, 577 (S.D. 1978).

29. *See, e.g.*, Flynn v. Sawyer, 272 N.W.2d 904, 908 (Minn. 1978); Thompson v. Thompson, 391 N.W.2d 608, 610 (N.D. 1986); Smith v. Michael Kurtz Construction Co., 232 N.W.2d 35, 39 (N.D. 1975); Carr v. Benike, Inc., 365 N.W.2d 4, 6 (S.D. 1985); Christiansen v. Strand, 81 S.D. 187, 192-93, 132 N.W.2d 386, 388-89 (1965).

30. 349 N.W.2d 552 (Minn. 1984).

31. 349 N.W.2d at 558.

32. S.D. CODIFIED LAWS ANN. § 53-8-2 (1987 Supp.).

33. *See, e.g.*, Aamot v. Eneboe, 352 N.W.2d 647 (S.D. 1984); Wiggins v. Shewmake, 374 N.W.2d 111 (S.D. 1985). *See generally* J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS §§ 19-26—19-39 (3d ed. 1987).

34. *See* J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS §§ 19-16, 19-47 (3d ed. 1987).

ing the issue in terms of promissory or equitable estoppel or pleading the cause of action in fraud or the covenant of good faith and fair dealing in order that the misrepresentations or bad faith conduct would not be excluded by operation of the Statute of Frauds.

Estoppel proved to be a successful way around the Statute of Frauds for the debtor in *White v. Production Credit Association of Alma*.[35] In this case, the debtor had been buying, raising, and selling feeder cattle since 1960. In 1970, the defendant PCA agreed to provide exclusive financing for the debtor and a loan of $128,000 was approved by the PCA. Because of drought and other problems, 1970 was a poor year for the debtor. The debtor and the PCA's agent discussed the feasibility of installing an irrigation system and both agreed that it would be the answer to his recent problems. The PCA agreed, according to the debtor, to finance the irrigation project and to provide financing for the balance of the operation, including the purchase of cattle each year for a period of seven to ten years. The irrigation equipment loan would be repaid in seven annual installments. As security for all of the financing, the PCA took mortgages and security interests in the debtor's real estate, crops, livestock, machinery and equipment, including the irrigation system. During the first year of this relationship, the PCA reversed its position and requested that the debtor obtain a refinancing for the irrigation equipment loan from another lending institution. The debtor was unable to find another lender. The PCA later refused additional funds for the purchase of cattle during the 1972 and 1973 seasons and the debtor was unable to secure alternative financing because all of his assets had been pledged to the PCA. Finally, in 1974, the debtor refinanced his entire operation with the FmHA. The debtor, however, suffered losses of $85,304 in 1972 and $34,445 in 1973, in large part due to the lack of financing from the PCA.[36]

At trial, the PCA admitted that the only reason it did not finance the purchase of cattle during 1972 and 1973 was that the debtor had not found an alternate lender to refinance the irrigation equipment loan. Its principal defense was that the debtor could not enforce any commitment to provide financing for purchase of cattle over a period of several years because there was no written memorandum to satisfy the Statute of Frauds. The trial judge denied the PCA's motion for summary judgment based on the Statute of Frauds defense and the jury returned a verdict in favor of the debtor for $100,000. The Michigan Court of Appeals affirmed, holding that a party may be estopped from asserting the Statute of Frauds defense.[37] The court relied on the doctrine of equitable estoppel set forth in Williston's treatise on contracts.[38]

Because the Statute of Frauds is intended to prevent fraud, it is said that

35. 76 Mich. App. 191, 256 N.W.2d 436 (1977).
36. *Id.* at —, 256 N.W.2d at 437.
37. *Id.* at —, 256 N.W.2d at 438.
38. "Where one has acted to his detriment solely in reliance on an oral agreement, an estoppel may be raised to defeat the defense of the Statute of Frauds."
3 WILLISTON ON CONTRACTS § 533A at 796 (Jaeger 3d ed. 1960).

it may not itself be used to shield or protect a party who seeks to perpetrate a fraud through oral statements reasonably relied upon by another party.[39] The Statute of Frauds was not intended to displace the well-established principles of estoppel.[40] For equitable estoppel, there must be false representations or concealment of material facts made to or withheld from a party who lacked knowledge of the real facts, which were intended to be acted or relied upon and were in fact relied upon.[41] Promissory estoppel is similar to equitable estoppel, except that the representations relate to future events.[42] For promissory estoppel, there must be a clear and definite oral agreement, proof that the party urging application of the doctrine acted to his or her detriment in relying on the agreement, and equity in favor of enforcement of the agreement.[43] The required elements of estoppel ensure that a party may not enforce an oral agreement solely on the grounds of nonperformance.[44] There must be a demonstration of facts in effect amounting to fraud or gross inequity.[45]

Waiver of Written Covenants and Conditions

Estoppel presents an important exception to the finality of written documents. Closely related is the concept of waiver.[46] Waiver does not relate to the formation of a contract, but rather to subsequent modification by agreement or actions of a completed contract. In the debtor-creditor relationship, this most commonly occurs in connection with the acceptance of late payments. The contract typically provides that time is of the essence and that strict compliance with all covenants and conditions is required of the debtor. The actions of both debtors and creditors, however, are often at variance with this contract language.

39. *See* Warder & Lee Elevator, Inc. v. Britten, 274 N.W.2d 339, 342 (Iowa 1979) (*citing* 3 WILLISTON ON CONTRACTS § 553A at 796 (Jaeger 3d ed. 1960)).

40. Warder & Lee Elevator, Inc. v. Britten, 274 N.W.2d 339, 342 (Iowa 1979); Miller v. Lawlor, 245 Iowa 1144, 1152-53, 66 N.W.2d 267, 272-73 (1954); Sacred Heart Farmers Cooperative Elevator v. Johnson, 305 Minn. 324, 326-27, 232 N.W.2d 921, 922-23 (1975); Annot., *Promissory Estoppel as a Basis for Avoidance of Statute of Frauds*, 56 A.L.R.3d 1037, 1050-52 (1974). *See generally* RESTATEMENT (SECOND) OF CONTRACTS § 217A (1981).

41. *See, e.g.*, Northwest Realty Co. v. Colling, 82 S.D. 421, 432, 147 N.W.2d 675, 682 (1966).

42. Southeastern Sales & Service Co. v. T.T. Watson, Inc., 172 So.2d 239 (Fla. App. 1965). *See generally* J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS §§ 19-47, 19-48 (3d ed. 1987).

43. Warder & Lee Elevator, Inc. v. Britten, 274 N.W.2d 339, 342 (Iowa 1979); Yankton Production Credit Ass'n v. Larsen, 219 Neb. 610, —, 365 N.W.2d 430, 433 (1985).

44. Warder & Lee Elevator, Inc. v. Britten, 274 N.W.2d 339, 343 (Iowa 1979).

45. Northwest Realty Co. v. Colling, 82 S.D. 421, 433, 147 N.W.2d 675, 682-83 (1966).

46. From a doctrinal standpoint, estoppel and waiver are not synonymous. "A waiver exists 'where one in possession of any right, whether conferred by law or by contract, and of full knowledge of the material facts, does or forbears the doing of something inconsistent with the existence of the right or of his intention to rely upon it. . . .' " Wieczorek v. Farmers' Mut. Hail Ins. Ass'n, 61 S.D. 211, 216-17, 247 N.W. 895, 897 (1933) (*quoting* Noem v. Equitable Life Ins. Co., 37 S.D. 176, 180, 157 N.W. 308, 309 (1916)). "To create an estoppel, there must have been some act or conduct upon the part of the party to be estopped, which has in some manner misled the party in whose favor the estoppel is sought and has caused such party to part with something of value or do some other act relying upon the conduct of the party to be estopped, creating a condition making it inadequate to allow the guilty party to claim what would otherwise be his legal rights. Somer v. Somers, 27 S.D. 500, 504, 131 N.W. 1091, 1093 (1911)." Western Casualty and Surety Co. v. American National Fire Ins. Co., 318 N.W.2d 126, 128 (S.D. 1982).

In *Cobb v. Midwest Recovery Bureau Co.*,[47] for example, the purchaser of a truck sued a financing company and its repossessing agent for wrongful repossession of his truck. Repossession had occurred because of the purchaser's failure to make timely payments on his retail installment purchase contract. The contract naturally provided for strict compliance with the payment schedule.[48] This was a problem account for the finance company. The purchaser was usually two payments behind schedule and those payments made were chronically late. Notwithstanding certain threats to terminate the contract, the finance company had accepted late payments from the purchaser over a period of nearly two years.[49] When the finance company finally decided to repossess, it hired Midwest Recovery Bureau for this purpose. Repossession was accomplished without any prior notice to the purchaser. At the time of repossession, the purchaser was two payments behind, but had only four payments totaling about $2000 remaining to be paid.

The trial court judge held that the repossession was wrongful as a matter of law and left the issue of damages to the jury. The jury awarded the purchaser compensatory damages, including lost profits, in the amount of $3,753.74 and punitive damages in the amount of $20,000. The Supreme Court of Minnesota affirmed the wrongful repossession holding and the accompanying award of compensatory damages, but reversed the award of punitive damages.[50] The court followed the approach of a majority of courts and held that when a creditor has regularly accepted late payments, there is a duty to notify the debtor that strict compliance with the contract terms will be required before the creditor can lawfully repossess the collateral.[51] The award of punitive damages was reversed because the court regarded the conduct as done with a "good faith reasonable interpretation of a statute which had not been construed by this court."[52]

Punitive damages in connection with a wrongful repossession were awarded in *Warren v. Ford Motor Credit Co.*[53] In this case, the original pur-

47. 295 N.W.2d 232 (Minn. 1980).

48. The contract language was as follows:

> Time is of the essence of this contract. If buyer shall fail to pay any installment when due hereunder, . . . then the full amount of the time balance shall become immediately due and payable. Thereupon, seller may take immediate possession of the property, including all equipment, attachments and accessories thereto, without notice or demand.

295 N.W.2d at 233.

49. Contract language also provided that any waiver of a breach or default would not constitute a waiver of any subsequent breach or default. The anti-waiver provision read as follows:

> No amendment of this contract shall be binding upon the seller unless in writing and signed by its duly authorized representative. . . . Any waiver of any breach or default shall not constitute a waiver or [sic] any other or [sic] subsequent breach or default.

295 N.W.2d at 233.

50. *Id.*

51. *Id.* at 236-37. The court cited the following authorities: Ford Motor Credit Co. v. Waters, 273 So.2d 96 (Fla. App. 1973); Pierce v. Leasing Int'l, Inc., 142 Ga. App. 371, 235 S.E.2d 752 (1977); Nevada Nat'l Bank v. Huff, 582 P.2d 364 (Nev. 1978); Lee v. Wood Prods. Credit Union, 275 Or. 445, 551 P.2d 446 (1976); Ford Motor Credit Co. v. Washington, 573 S.W.2d 616 (Tex. Civ. App. 1978).

52. *Id.* at 237.

53. 693 F.2d 1373 (11th Cir. 1982).

chaser had given possession of the car to the Warrens in exchange for their taking over the payments. Payments on the contracts were often late, but always accepted by the defendant. The last payment was due on March 10, 1976, and, as usual, payment was not made on that date. The defendant repossessed the car, which at the time was in the repair shop, without giving notice to the Warrens. Mrs. Warren tendered what she believed would be the final payment on March 20. The defendant, however, went ahead with the sale of the vehicle. The suit for wrongful conversion and failure to give proper notice resulted in a jury award of $1,350 compensatory damages and $54,100 in punitive damages. The Eleventh Circuit Court of Appeals affirmed the finding of wrongful repossession but used its remittitur power to reduce the punitive damages award to $20,000.[54]

Punitive damages were proper under the circumstances in this case because the course of dealing between the parties had established a waiver of strict compliance with the payment due date. To allow a creditor to repossess when the last payment was not made on time would amount to a forfeiture. Such conduct on the part of the creditor was outrageous and justified the award of punitive damages, even if for a lesser amount.

Is there any way for a creditor to protect itself at the outset from a subsequent claim of waiver? Ordinarily no, if the conduct of the parties amounts to a waiver or modification of the original contract. In *Westinghouse Credit Corp. v. Shelton*,[55] for example, the assignee of a retail installment contract for the purchase of a mobile home brought an action for repossession of the mobile home on account of default by the purchaser. The plaintiff-assignee's motion for summary judgment was granted by the district court. It was not disputed that the purchaser of the mobile home was in default at the time of the lawsuit. Over the course of the relationship, the purchaser had paid nearly all of approximately forty installments late, some as late as three months. The plaintiff had accepted all late payments made during this 3½-year period. It was the purchaser's position that the plaintiff could not insist upon strict compliance with the contract's timeliness provisions without first apprising the purchaser of this change in their course of conduct. The plaintiff stood on the "anti-waiver" clause in the contract. The Tenth Circuit Court of Appeals held that the "anti-waiver" clause was like any other contractual clause and therefore subject to waiver or modification. Whether such waiver had occurred in this case was a question of fact, making summary judgment improper.[56]

The waiver argument generally cannot be defeated through drafting technique alone. Subsequent conduct can work a modification or waiver of even the most carefully drafted contractual provision. Creditors usually prefer some flexibility in working out late or missed payment problems. When the creditor makes the judgment that informal means of collection will no longer work and that the formal collection or foreclosure process must now be uti-

54. *Id.* at 1380.
55. 645 F.2d 869 (10th Cir. 1981).
56. *Id.* at 873-74.

lized, the majority view is that there must be proper notice to the debtor of the change in the course of dealing between the parties. The creditor does not waive the right to receive timely payment if it accepts some late payments, but it may not stand on its contract rights until notice is given.

As noted in *Cobb v. Midwest Recovery Bureau, Inc.*,[57] not all jurisdictions allow oral modification of a written contract if the contract requires any modification to be in writing. In *Williams v. Ford Motor Credit Co.*,[58] the plaintiff sought damages for wrongful conversion of an automobile. It was the plaintiff's contention that the financing company had agreed over the telephone to accept late payment. Default and acceleration of the contract balance were declared by the financing company, however, before the payment was received. The trial court directed a verdict in favor of the financing company on the ground that the plaintiff's allegations were insufficient because the security agreement required any modification of the timeliness provision to be in writing. This ruling was affirmed on appeal by the Supreme Court of Alabama.[59]

The debtor should therefore not assume that the informality and flexibility which may have been characteristic of the credit relationship will always override the written contract signed by the parties. Courts are often reluctant to disregard the formal agreement made at the outset of the relationship.[60] Only by a clear showing of waiver or facts amounting to an estoppel will the legal effect of the strict contract provisions be tempered by the conduct of the parties.[61]

Damages

Calculation of damages for breach of contract in the lender liability area does not present unusual difficulties. The purpose of contract damages is "to place the aggrieved party in the same economic position he would have had if the contract had been performed."[62] This naturally involves a degree of spec-

57. 295 N.W.2d 232, 236 (Minn. 1980).

58. 435 So.2d 66 (Ala. 1983).

59. *See also* Hale v. Ford Motor Credit Co., 374 So.2d 849 (Ala. 1979).

60. *See, e.g.*, Flagship Nat'l Bank v. Gray Distribution Systems, Inc., 485 So.2d 1336 (Fla. App. 1986); Van Bibber v. Norris, 419 N.E.2d 115 (Ind. 1981).

61. For additional cases involving a waiver of strict performance or modification of the contract, *see* Sahadi v. Continental Illinois Nat'l Bank & Trust Co., 706 F.2d 193 (7th Cir. 1983) (bank had previously accepted late payments and the payment at issue was only one day late); Mayo v. Bank of Carroll County, 157 Ga. App. 148, 276 S.E.2d 660 (1981) (acceptance of late payments throughout the course of the loan raised issue of waiver or modification when the payment at issue was tendered two days late); Schaller v. Marine Nat'l Bank of Neenah, 131 Wis. 2d 389, 388 N.W.2d 645 (Wis. App. 1986) (bank's previous honoring of overdrafts did not oblige the bank to give notice before dishonoring additional overdrafts).

62. J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 14-4 (3d ed. 1987). Problems occur when the damages cannot be ascertained with some reasonable certainty. For example, if the breach prevented the injured party from starting a new and unproven business venture, the court is likely to find that the damages are too uncertain and speculative to be allowed. *See, e.g.*, Howarth v. Ostergaard, 30 Utah 2d 183, 515 P.2d 442 (1973). On the other hand, absolute certainty is not required. "Reasonable certainty" is sufficient. RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981).

There may be a trend in the more recent case law to the effect that once the fact of damages is clearly established, the amount of the damage need not be demonstrated with precision. *See* Mann v. Weyerhouser Co., 703 F.2d 272 (8th Cir. 1983); A to Z Rental, Inc. v. Wilson, 413 F.2d 899 (10th ulation, but no more generally than in other cases. The guiding principle for consequential damages, from *Hadley v. Baxendale*,[63] is that the damages must have been within the contemplation of the parties as a probable consequence of the breach.

The most common damage recovery in this area is for loss of profits which would have been earned had the lender not breached its contract.[64] Because the general purpose of contract damages is to simulate performance, recoverable damages are often less than under comparable theories. Consequential damages of any kind must have been foreseeable. Punitive damages are not recoverable.[65]

In *National Farmers Organization v. Kinsley Bank*,[66] the Tenth Circuit affirmed a finding of breach of a commitment to loan money, but reversed the jury's award of consequential damages because the damages were not within the contemplation of the parties. The debtor in this case was unable to purchase lambs, but the evidence indicated that he would have lost money had the purchase occurred. The debtor contended that he could have purchased, resold, and purchased another group of lambs on which he could have made a profit. The court did not deny this possibility, but reversed the award of lost profits because profits which could have been made on a second purchase were not within the contemplation of the parties at the time of the loan commitment.[67] The court also affirmed the district court's refusal to instruct on punitive damages because there was no independent tort involved.[68]

Efforts to circumvent the traditional prohibition on punitive damages in contract actions has led to creative pleading in some instances. The strategy is to characterize the facts surrounding the creditor's broken promise as a breach of the implied covenant of good faith and fair dealing or even a tort, such as

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Cir. 1969); El Fredo Pizza, Inc. v. Roto-Flex Oven Co., 199 Neb. 697, 261 N.W.2d 358 (1978). The amount of anticipated profits need not be calculable with complete precision, so long as there is proof that there would have been profits and that the loss of profits resulted from the other party's wrongdoing. Stensvad v. Miners and Merchants Bank of Roundup, 196 Mont. 193, 640 P.2d 1303, *cert. denied*, 459 U.S. 831 (1982); Stone v. Caroselli, 563 P.2d 754 (Colo. App. 1982). In *Stensvad*, an award of damages for lost profits of a cattle feeding venture was disallowed by the Montana Supreme Court because there was no certainty that there would have been any profits or that profits were lost as a result of the breach. The holding made clear, however, that if these elements had been satisfied, damages for lost profits could have been recovered.

63. 156 Eng. Rep. 145 (1854).

64. *See, e.g.*, In re Knickerbocker, 827 F.2d 281 (8th Cir. 1987) (jury award of lost profits in the amounts of $375,000 to one partner and $400,000 to another partner reduced by the Eighth Circuit to $145,000 and $155,000, respectively); Harsha v. State Savings Bank, 346 N.W.2d 791 (Iowa 1984) (jury award of $126,000 for lost profits which borrower would have realized if bank had not breached its contract to lend $25,000 was affirmed by the Iowa Supreme Court); White v. Production Credit Ass'n of Alma, 76 Mich. App. 191, 256 N.W.2d 436 (1977) (jury award of $100,000 lost profits affirmed by the court of appeals); Farm Crop Energy, Inc. v. Old National Bank of Washington, 38 Wash. App. 50, 685 P.2d 1097 (1984) (jury award of $295,000 for lost profits of a fuel alcohol venture was affirmed on appeal). *But see* Coastland Corp. v. Third National Mortgage Co., 611 F.2d 969 (4th Cir. 1979) (anticipated profits from a new or unestablished business, or one merely in contemplation, cannot be recovered because such profits are not certain to have been realized).

65. *See, e.g.*, D. DOBBS, REMEDIES § 12.4 (1973).

66. 731 F.2d 1464 (10th Cir. 1984).

67. *Id.* at 1471-72.

68. *Id.* at 1473.

fraud or conversion. To the extent this strategy is successful, the creditor's exposure increases.[69]

Many courts, however, thwart the attempt to expand the range of damage recovery through adroit pleading alone. They require allegation of facts amounting to something more than a simple breach of contract. The *Kinsley Bank* court, for example, rejected the debtor's attempt to plead a count of fraud in addition to the breach of contract claim.[70] The debtor would have to show that the creditor knowingly made a false promise with the intent that the debtor rely upon it to his detriment.[71] It is not sufficient that the debtor alleges facts constituting the breach of contract and then add that the creditor did this willfully, with malice, and in reckless disregard of the debtor's interests.[72]

Although the debtor-creditor relationship is grounded upon contract, the lender liability cases are by no means limited to application of contract theory. The relationship can be scrutinized through theories, both common law and statutory. The remainder of this article indicates some of the ways in which debtors have been successful in pleading a lender liability theory outside of the contracts area.

THE COVENANT OF GOOD FAITH AND FAIR DEALING

In the realm of contracts, the parties remain largely in control of their own destiny. Their agreement defines the respective rights and obligations of the parties. The law of contracts is not entirely self-contained, however. At times, rights or obligations, including standards of performance, come from such outside sources as the custom or usage in the trade.[73] Another important supplement to the contract is supplied by public law in the form of the implied covenant of good faith and fair dealing.

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69. *See, e.g.,* Warren v. Ford Motor Credit Co., 693 F.2d 1373 (11th Cir. 1982) (court approved an award of punitive damages in the amount of $20,000 for wrongful repossession of the debtors' car).

70. National Farmers Organization v. Kinsley Bank, 731 F.2d 1464, 1472-73 (10th Cir. 1984).

71. *Id.* at 1473.

72. *See* Wait v. First Midwest Bank/Danville, 142 Ill. App. 3d 703, —, 491 N.E.2d 795, 801-02 (1986); Rodgers v. Tecumseh Bank, 1988 WL 32722, 56 U.S.L.W. 2615 (Supreme Court of Oklahoma, April 13, 1988) (affirming summary judgment in favor of the bank on plaintiff's claim for "tortious breach of contract").

A recent unpublished decision by United States District Judge Andrew W. Bogue confirms this limitation. In Deday v. Production Credit Ass'n of the Midlands (No. Civ. 86-5026, D.S.D. 1987), the plaintiffs sought to supplement their complaint for breach of contract with additional counts sounding in tort. This district court dismissed the additional counts, relying on Ochs v. Northwestern National Life Insurance Co., 254 N.W.2d 163, 167-68 (S.D. 1977). *Ochs* authorizes dismissal of additional causes of action which sound in tort but which are based on the defendant's breach of their contractual duties.

73. *See, e.g.,* UCC § 1-205. *See also* Carter Baron Drilling v. Badger Oil Corp., 581 F. Supp. 592, 595 (D. Colo. 1984) (evidence of usage of trade, course of dealing and course of performance can be introduced to explain or supplement a contract); Major's Furniture Mart, Inc. v. Castle Credit Corp., 449 F. Supp. 538, 543 (E.D. Pa. 1978), *aff'd*, 602 F.2d 538 (3d Cir. 1979) (course of performance of an agreement is a useful indication of the parties' intent).

The covenant of good faith and fair dealing is implied in *every* contract.[74] It requires that all parties to the contract shall not do anything which will have the effect of destroying or depriving the right of the other parties to receive the anticipated benefits of the contract.[75] This prevents parties from undermining the basis or reason upon which the contract was formed.

The covenant of good faith and fair dealing imposes affirmative duties in addition to restricting the conduct of the parties.[76] As Professor Williston stated: "[W]herever the cooperation of the promisee is necessary for the performance of the promise, there is a condition implied in fact that cooperation will be given."[77] The obligation of good faith and in particular the duty to cooperate means that the parties may not purposely destroy the benefits of the contract. It limits the ability to play "hardball."

The covenant, therefore, has obvious importance for the lender liability

74. *See, e.g.,* UCC § 1-203. *See also* Universal Sales Corp. v. California Press Mfg. Co., 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942).

It should be emphasized that the covenant is a general principle of law. Although the chief application of the covenant to date has been in the insurance area, the covenant has been applied in many different contexts. *See, e.g.,* Chancellier v. Federated Dept. Stores, 672 F.2d 1312, 1318 (9th Cir.), *cert. denied,* 459 U.S. 859 (1982) (covenant applied to employment agreement); Wagenseller v. Scottsdate Memorial Hosp., 147 Ariz. 370, 710 P.2d 1025 (1985) (covenant applied to employment-at-will contract); Seaman's Direct Buying Service v. Standard Oil Co., 36 Cal. 3d 752, 206 Cal. Rptr. 354, 686 P.2d 1158 (1984) (covenant of good faith and fair dealing applied in connection with a supply contract); Brown v. Superior Court, 34 Cal. 2d 559, 564, 212 P.2d 878, 881-82 (1949) (covenant applied to agreement to make mutual wills); Nelson v. Abraham, 29 Cal. 2d 745, 750-51, 177 P.2d 931, 934 (1947) (covenant applied to partnership agreement); Wind v. Herbert, 186 Cal. App. 2d 276, 284, 8 Cal. Rptr. 817, 821 (1960) (covenant applied to partnership accounting); Harm v. Frasher, 181 Cal. App. 2d 405, 417, 5 Cal. Rptr. 367, 374 (1960) (covenant applied to the sale of a partnership business); Nicholson v. United Pacific Insurance Co., 710 P.2d 1342 (Mont. 1985) (covenant applied to lease agreement); Morse v. Espeland, 696 P.2d 428 (Mont. 1985) (covenant applied to attorney/client fee arrangement); EKE Builders, Inc. v. Quail Bluff Associates, 714 P.2d 604 (Okla. App. 1985) (covenant applied to construction contract).

There remains, however, some reluctance to apply the covenant of good faith and fair dealing outside of the insurance context. *See, e.g.,* Iron Mountain Sec. Storage v. American Specialty Foods, Inc., 457 F. Supp. 1158, 1166-68 (E.D. Pa. 1978); Rodgers v. Tecumseh Bank, 1988 WL 32722, 56 U.S.L.W. 2615 (Supreme Court of Oklahoma, April 13, 1988); Farris v. U.S. Fidelity & Guar. Co., 284 Or. 453, 463, 587 P.2d 1015, 1020 (1978). *See also* Diamond, *The Tort of Bad Faith Breach of Contract: When, If at All, Should It Be Extended Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425 (1981).

75. United States v. Fallbrook Public Utility Dist., 193 F. Supp. 342, 358 (S.D. Cal. 1961); Guin v. Ha, 591 P.2d 1281, 1291 (Alaska 1979); Universal Sales Corp. v. California Press Mfg. Co., 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942); Association Group Life, Inc. v. Catholic War Veterans, 61 N.J. 150, —, 293 A.2d 382, 384 (1972); Shaw v. E.I. duPont de Nemours & Co., 126 Vt. 206, —, 226 A.2d 903, 906 (1966).

76. Harm v. Frasher, 181 Cal. App. 2d 405, 417, 5 Cal. Rptr. 367, 374 (1960):

> This covenant not only imposes upon each contracting party the duty to refrain from doing anything which would render performance of the contract impossible by any act of his own, but also the duty to do everything that the contract presupposes that he will do to accomplish its purpose.

See also Berkeley Lawn Bowling Club v. City of Berkeley, 42 Cal. App. 3d 280, 286-87, 116 Cal. Rptr. 762, 766 (1974); Milstein v. Security Pacific National Bank, 27 Cal. App. 3d 482, 486, 103 Cal. Rptr. 16, 18 (1972); Ihlenfeldt v. Guastella, 42 Mich. App. 384, —, 202 N.W.2d 327, 331 (1972); Laconia Clinic, Inc. v. Cullen, 119 N.H. 804, —, 408 A.2d 412, 413-14 (1979); Onderdonk v. Presbyterian Homes of N.J., 85 N.J. 171, —, 425 A.2d 1057, 1065 (1981).

77. 6 WILLISTON ON CONTRACTS § 887 at 427-30 (3d ed. 1962). *See also* Minmar Builders, Inc. v. Beltway Excavators, Inc., 246 A.2d 784, 787-88 (D.C. App. 1968); Kaltoft v. Nielsen, 252 Iowa 249, —, 106 N.W.2d 597, 602 (1960); Gregerson v. Jensen, 617 P.2d 369, 373 n.9 (Utah 1980); Metropolitan Park Dist. v. Griffith, 106 Wash. 2d 425, —, 723 P.2d 1093, 1100 (1986).

area. Its primary impact occurs at the time of "default" by the debtor or in connection with the lender's enforcement of remedies subsequent to default. The covenant also may provide guidance for recognition of implied obligations arising during the course of the debtor-creditor relationship prior to default.

Good Faith and Fair Dealing Prior to Default

Returning once again to the case of *Yankton Production Credit Association v. Larsen*,[78] the Nebraska Supreme Court used the covenant of good faith and fair dealing to augment the obligations of the PCA. The PCA claimed an absolute right to refuse further advances of the budget loan. The terms of the contract itself lent support to this position.[79] The position asserted in the litigation was inconsistent, however, with the PCA's own normal operating procedures. In any event, the court held the PCA to a standard of good faith in the decision to cut off funds. If the PCA's refusal to advance funds was based on "a reasonable, good faith business judgment," then no liability. If not based on a good faith business judgment, there would be liability for the damages caused as a result of that action.[80]

The application of the covenant of good faith and fair dealing in this case is intended to protect the good faith business judgment and to inhibit the bad faith or arbitrary actions of the lender. The purpose of the loan agreement was to provide a continuing line of credit for the debtors' operation. Refusal of further advances on the agreed-upon line of credit could only undermine the essential purpose of the contract.

It is evident from the cases that lenders may be placed in undue jeopardy because the determination to cut off further credit may not always be clearly a matter of good faith or bad faith. The leading case in this area, *K.M.C., Inc. v. Irving Trust Co.*,[81] illustrates this difficulty. In *K.M.C.*, the debtor was a corporation engaged in the wholesale and retail grocery business. The debtor had a financing arrangement with Irving Trust for a line of credit of $3.5 million, secured by the debtor's accounts receivable and inventory. The parties continued with this relationship for approximately three years. Irving Trust then refused to advance a requested $800,000. The request would have increased the outstanding loan balance to just under the $3.5 million limit. The debtor alleged that as a result of the refusal to advance funds the company collapsed as a viable business entity. Irving Trust asserted that its "decision not to advance funds was made in good faith and in the reasonable exercise of its discretion under the agreement."[82] A jury found in favor of the debtor and fixed damages at $7.5 million, plus pre-judgment interest.[83] The Sixth Circuit Court of Appeals affirmed.

78. 219 Neb. 610, 365 N.W.2d 430 (Neb. 1985).
79. *Id.* at —, 365 N.W.2d at 432.
80. *Id.* at —, 365 N.W.2d at 434.
81. 757 F.2d 752 (6th Cir. 1985).
82. *Id.* at 754.
83. *Id.* at 755.

The financing arrangement between the parties virtually cried out for an implied good faith standard. The receipts of the debtor were placed into a "blocked account" to which Irving Trust had sole access. The effect was to control the operating funds of the debtor and keep the debtor at the mercy of the lender for continued use of the funds. The court therefore held that in these circumstances the lender was required to give a reasonable period of notice that the financing would be curtailed. Such notice would give the debtor an opportunity to seek alternative financing without suffering an immediate disruption of the business.[84]

Irving Trust also contended that the good faith standard would be satisfied if the loan officer who made the decision to terminate financing *believed* there existed valid reasons to support the decision.[85] In short, it argued for a subjective good faith test. The court, however, held the exercise of judgment to an objective standard and found substantial evidence to support the finding that no reasonable loan officer in the same situation would have refused to advance funds.[86] The evidence indicated that the loan was fully secured and that nothing in the debtor's business indicated any crisis or inability to repay the loan. Accordingly, the court held that the lender violated its obligation of good faith performance when it cut off the financial lifeline without prior notice.[87]

The principal case cited in opposition to the result in *K.M.C.* is *Centerre Bank of Kansas City v. Distributors, Inc.*[88] The factual circumstances are similar to *K.M.C.* in that it involved a cutting off of credit to the debtor's business operation, but there are important factual differences as well. In *Centerre Bank*, the debtor was a corporation which distributed kitchen appliances to builders in the Kansas City area. The corporation was owned by one Bronfman. In 1979, the corporation obtained a line of credit from the bank. Bronfman executed a note in the face amount of $900,000, payable on demand. The note was secured with accounts receivable and inventory and Bronfman's personal guarantee of the note. The building industry was depressed in 1979-80 and the corporation was not profitable. Bronfman looked for a buyer in 1981. Eventually a purchase of the corporation was arranged with several members of the Brown family. The sale was completed in May, 1981. The bank wanted personal guarantees from the new owners in addition to the guarantee from Bronfman. One family member testified that a bank official was pleased with the new management and that financing would continue if the personal guarantees were furnished. The personal guarantees were delivered to the bank on August 18, 1981. Three days later, the bank notified the Browns that it was giving 60 days notice that it would demand payment on the note.[89]

84. *Id.* at 759.
85. *Id.* at 760.
86. *Id.* at 761.
87. *Id.* at 762.
88. 705 S.W.2d 42 (Mo. App. 1985).
89. *Id.* at 44-45.

At this point, the bank's actions were even more egregious than Irving Trust's. However, the bank in fact continued to provide financing.[90] Between August 19 and December 15, the bank loaned the corporation almost $635,000 and the corporation made substantial payments to the bank. On December 15, the bank gave notice that it would demand payment by December 28. The owners surrendered the collateral, but there was a deficiency of over $385,000. The bank sued Bronfman and the Browns to collect the deficiency. The Browns counterclaimed based on a theory of bad faith. The jury trial resulted in a verdict of over $7.5 million in favor of the Browns.[91] The Missouri Court of Appeals reversed.

The court allowed the lender to stand on its contractual rights. It noted that the demand note constituted an agreement that the note could be called at any time. The good faith requirement would add a term to the contract which the parties had not included. "The 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."[92] The court could not approve the imposition of this additional term and thereby rewrite the agreement.

The *Centerre Bank* decision raises the issue of the applicability of an implied covenant to a written contract. The court took the position that parties have exclusive control of the creation of rights and obligations. The implied covenant is viewed as an intrusion upon the parties' autonomy. In opposition to this position is the view that the parties contract within an existing context of state law and public policy. This context is assumed to be applicable to the contractual relationship unless the parties expressly disclaim this supplemental law and policy. Ordinarily, this does not occur. Parties entering into a contractual relationship do not assume the worst. The Browns certainly did not anticipate, having given personal guarantees to the bank as a condition of continued financing, that there would be notice of intention to call the note within three days. To hold that the "deal" is confined strictly to the four corners of the written contract ignores the clear motivation of the debtors for entering into the contract.

The better view is expressed in *K.M.C.* and *Larsen*. To presume that the parties think through all potential problems and assume the risk that whatever is not prohibited is permitted ignores commercial realities as well as common sense. Moreover, the contractual relationship is not purely a private matter. The standard of conduct in commercial relationships is a matter of public concern. The covenant of good faith and fair dealing is an expression of public policy regarding the minimum standards of conduct for parties during the course of their contractual relationship.

Application of the implied covenant in this situation does not prevent the

90. This helps to distinguish the *K.M.C.* case and shifts somewhat the equities.
91. 705 S.W.2d at 44.
92. *Id.* at 48.

lender from cutting off further funding to the financially shaky debtor. What is required is exercise of reasonable judgment. In *Central Bank of Montana v. Eystad*,[93] the Supreme Court of Montana affirmed a judgment of foreclosure against the debtors' real property, notwithstanding assertion of a counterclaim based upon bad faith. The bank had made an operating loan to the debtors in connection with their business. The loan was secured by mortgages on the debtors' home and business property. The note was payable in six months, but the parties agreed to roll over the indebtedness each time the note became due. Over the course of several years, the debtors increased the amount of their indebtedness, often paying interest only for the period of the note. Eventually, the bank requested that the debtors reduce the outstanding principal. When the debtors could not do this, the bank agreed to a ninety-day extension of the note, instead of the usual six-month extension. Upon expiration of the ninety-day period, the debtors and the bank continued to negotiate for another two months. Finally, the bank decided that no further extensions could be granted and filed suit on the note. Both the trial court and the Montana Supreme Court found the bank's decision to be reasonable. The bank had no duty to renew or extend the note indefinitely.[94] There was ample evidence here of compliance with a good faith performance standard.

Good Faith and Fair Dealing Upon or After Default

As noted above, the primary setting for the application of the covenant of good faith and fair dealing arises upon the declaration of default by the lender and the enforcement of debt collection remedies thereafter. In the former instance, the question will concern the good faith of the lender in declaring the default under an open-ended default provision. The question in the latter instance concerns the appropriate measures which may be taken to secure payment.

When a lender has drafted an open-ended default clause, abuse of the power to declare a default is a distinct possibility. In *Brown v. Avemco Investment Corp.*,[95] the security agreement provided that sale, lease, transfer or encumbrance of the collateral (an airplane) would constitute default, unless the written consent of the creditor had been obtained. In addition, the creditor could declare a default "if for any reason [the creditor] may deem itself insecure."[96] The plaintiffs subsequently leased the airplane from the original debtor without obtaining the consent of the creditor. Notice of the lease was given, however, and payments were regularly made for two years thereafter. The plaintiffs then offered to make payment of the outstanding balance, but the creditor refused and instead declared a default on account of the unauthor-

93. 710 P.2d 710 (Mont. 1985).
94. *Id.* at 713.
95. 603 F.2d 1367 (9th Cir. 1979).
96. *Id.* at 1369. The option to accelerate the debt at will has been tempered by the Uniform Commercial Code to require a good faith belief that the prospect of payment or performance is impaired. *See* UCC § 1-208.

ized lease. The plane was repossessed and sold for more than the outstanding balance.[97] Suit was filed by the plaintiffs for conversion. Judgment was rendered in favor of the creditor, but this was reversed on appeal by the Ninth Circuit.

The court held that it was error to refuse an instruction that the creditor could accelerate the debt only if it believed in good faith that the security was impaired by breach of the security agreement.[98] Acceleration clauses are designed to protect the creditor against impairment of the security; they are not intended to provide an offensive weapon to be used for commercial advantage. The court therefore incorporated existing principles of good faith into its interpretation of the security agreement.

Reasonable restriction on the creditor's ability to accelerate the indebtedness gives greater stability to the debtor-creditor relationship by preventing surprise and deprivation of the parties' expectations. In *Williamson v. Wanlass*,[99] the debtors purchased farm property with the sellers taking a note for the balance of the purchase price. The debtors were often late in making monthly payments, but the payments were accepted and there was no notice given that strict compliance with payment due dates would be demanded by the sellers. When one payment was not received on time, the sellers asked their attorney to give notice of acceleration and demand for the entire balance. The court observed that strict enforcement of the acceleration provision could result in a forfeiture, a result generally disfavored in the law.[100] The court required that the sellers have a good faith belief that the prospect of payment was impaired before declaring the acceleration and reversed the judgment in favor of the sellers.[101]

In a similar fashion, the Supreme Court of Montana found a breach of the obligation of good faith in connection with acceleration of an outstanding loan. In *First National Bank in Libby v. Twombly*,[102] an employee of the bank agreed to renegotiate the repayment of a loan with an impending due date. This employee was out of town when the debtors sought to finalize this understanding. The bank's vice-president disclaimed any intention to renegotiate and, when the debtors indicated that they would be unable to pay the loan on the due date, he authorized an offset against the debtors' account with the bank. The Montana Supreme Court concluded that the bank breached its obligation of good faith.[103]

The Montana Supreme Court elaborated further in *Noonan v. First Bank Butte*[104] on the standard for determining whether the covenant of good faith has been breached. In *Noonan*, the debtors were partners of a wholesale meat

97. *Brown*, 603 F.2d at 1375.
98. *Id.* at 1380.
99. 545 P.2d 1145 (Utah 1976).
100. *Id.* at 1147.
101. *Id.* at 1149.
102. 689 P.2d 1226 (Mont. 1984).
103. *Id.* at 1230.
104. 740 P.2d 631 (Mont. 1987).

operation. They borrowed funds from the bank for expansion of their operation, totalling almost $200,000 by 1975. In 1980, the bank requested financial statements as part of a review of the loan status. The statements provided were accurate, but incomplete with respect to the brothers' entire operations. The statements did not disclose other debt incurred in connection with other operations. On the basis of the financial statements, the bank agreed to continue the loans and even increased the outstanding balance to $320,000. In 1982, the bank met with the brothers to discuss one of the outstanding and then delinquent loans. At that time, the brothers disclosed the full extent of their indebtedness. Upon advice of counsel, the bank then froze the funds in the partnership checking account, cashed in certificates of deposit, and eventually repossessed and liquidated the partnership assets. After going through bankruptcy, the brothers filed a suit against the bank based on the covenant of good faith and fair dealing. The jury returned a verdict for $800,000 in lost profits and $700,000 for emotional distress.[105]

The Montana Supreme Court reversed and remanded for a new trial. It held that the jury was not properly instructed on the covenant of good faith and fair dealing. Breach of the Uniform Commercial Code standard of "honesty in fact" was not sufficient to support liability.[106] "The minimal requirement for the tortious breach of the covenant of good faith and fair dealing is action by the defendant which was arbitrary, capricious or unreasonable, and exceeded plaintiffs' justifiable expectation."[107] This standard comports with the underlying purpose of the covenant which is to prevent the unjustified denial of the reasonably anticipated benefits of the contractual agreement.

The imposition of a good faith standard is not intended to put the creditor at risk whenever it declares an acceleration of the debt. What is required is good faith in the exercise of judgment. The Indiana Court of Appeals held that it was error to refuse an instruction offered by the creditor with respect to its good faith belief that repayment was uncertain and that realization of the value of the collateral was insecure.[108] The test for good faith, however, is not subjective with the creditor. Instead, the creditor's exercise of judgment is measured against what a "reasonable man" would have done under similar circumstances.[109]

Sometimes, the objective standard is supplied by commercial or trade practice. After repossession, the seller may liquidate the collateral and should do so in a "commercially reasonable" manner.[110] In the repossession and liquidation context, the rights and obligations of the parties are supplemented by the provisions of the Uniform Commercial Code. These provisions are

105. *Id.* at 634.

106. The court also held that the statutory duty of good faith expressed in UCC § 1-203 did not preempt any common law obligation of good faith and fair dealing. *Id.*

107. *Id.* at 635.

108. Universal C.I.T. Credit Corp. v. Shepler, 329 N.E.2d 620 (Ind. App. 1975).

109. *Id.* at 624.

110. UCC §§ 9-504(3) & 9-506(2). *See also* Washburn v. Union Nat'l Bank & Trust Co., 151 Ill. App. 3d 21, 502 N.E.2d 739 (1986).

designed to encourage commercially reasonable conduct and to prevent the secured party from creating a deficiency by its own bad faith conduct.[111]

Damages

The assertion that a creditor has violated the covenant of good faith and fair dealing may serve to block the foreclosure of a mortgage or repossession of property. It may also serve an offensive purpose by supporting a claim for damages. Indeed, one of the chief attractions of this theory is its relatively enhanced measure of damages. Even though the implied covenant of good faith and fair dealing appears to be related to contract law, recovery of damages for breach of the implied covenant follows instead the tort model. Not only does this allow for a greater recovery of actual and consequential damages,[112] but it also raises the prospect of punitive damages, which are not recoverable in contract actions.[113]

The possibility of greater recovery under this theory may be seen in *Alaska Statebank v. Fairco*.[114] The creditor in this case breached an oral agreement not to proceed against the collateral without giving prior notice to the debtor. Despite this agreement, a bank official and two employees, a locksmith, and a police officer arrived at the debtor's place of business, told the customers to leave, changed the locks, and shut down the business. The bank offset against the debtor's bank account, refused to honor any checks drawn on the account, and told the payees that the business was closed.[115] The owners of the business sued the bank, alleging a breach of the duty to conduct itself in good faith and sought damages for defamation and wrongful repossession. Damages for defamation in the amount of $10,000 were affirmed by the Alaska Supreme Court. The court also affirmed a verdict for punitive damages in the amount of $35,000 on account of the wrongful repossession.[116]

Punitive damages in the amount of $20,000 were also recoverable on ac-

111. For additional cases exonerating the creditor's exercise of judgment and holding against the debtor's bad faith claim, *see* Washburn v. Union Nat'l Bank & Trust Co., 151 Ill. App. 3d 21, 502 N.E.2d 739 (1986); Smith v. Union State Bank, 452 N.E.2d 1059 (Ind. App. 1983); First Nat'l Montana Bank v. McGuiness, 705 P.2d 579 (Mont. 1985); State Bank of Lehi v. Woolsey, 565 P.2d 413 (Utah 1977).

112. The $7.5 million judgment affirmed in K.M.C., Inc. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985), for example, exceeded the entire value of the aggrieved business on the date of the breach of the covenant of good faith. The damages in *K.M.C.* were calculated on the prospective earnings and were premised on greater corporate value resulting from corporate expansion. *Cf.* Fehrs v. United States, 223 Ct. Cl. 488, 620 F.2d 255 (1980) where the court rejected a valuation based on prospective earnings and premised on improved performance following a change in management. The *Fehrs* court found such damages to be "naked speculation," supported only by an expert's conclusory supposition to that effect. 620 F.2d at 265. The *K.M.C.* court, on the other hand, found that there was substantial evidence to support K.M.C.'s expert's assumptions used in valuing the business. 757 F.2d at 764 n.14. If there is substantial evidence to support a method of calculation of the damages claimed, it would appear that the resulting verdict will be allowed to stand.

113. *See, e.g.*, Commercial Cotton Co. v. United California Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) ($100,000 punitive damage award upheld in connection with a breach of the covenant of good faith and fair dealing).

114. 674 P.2d 288 (Alaska 1983).

115. *Id.* at 290.

116. *Id.* at 297.

count of a wrongful repossession in *Clayton v. Crossroads Equipment Co.*[117] The Utah Supreme Court affirmed a lower court finding that the creditor sought to extract as much money as possible from the debtor before repossession of a combine and had enticed the debtor to make the combine available for repossession by means of a false representation that he had crops to harvest.[118] The conduct of the creditor was malicious and caused maximum injury to the interests of the debtor. Hence, the repossession was not made in good faith.

The greater potential for damages is due in part to the difference in the foreseeability in tort and contract actions. It also reflects the fact that the theory of good faith puts the motive or purpose of the creditor in issue. If the presentation of the case goes favorably for the debtor, evidence of bad faith inevitably enhances the award of damages from the jury. Such evidence also shifts the settlement posture of the case. The debtor's attorney therefore is well advised to consider the possibility of this theory when evaluating the case.

FIDUCIARY DUTIES OF THE CREDITOR

Of all the theories of lender liability, the assertion of a claim or defense based upon breach of a fiduciary duty by the lender has met with the least success. The reason for this is relatively simple: the debtor-creditor relationship does not ordinarily fit the traditional model for the recognition of a fiduciary duty. Both debtor and creditor will seek to further their own respective interests and may do so without restriction as long as they do not breach the covenant of good faith and fair dealing. This relationship is often characterized as "arms-length." The fiduciary model, on the other hand, requires that the fiduciary hold a special position of confidence or trust, that the beneficiary rely upon the judgment of the fiduciary and is dependent upon the performance or exercise of judgment by the fiduciary.[119] The fiduciary relationship is the antithesis of an arms-length relationship.

In the context of actual cases, however, there may be some temptation to use the fiduciary model if there are certain factors present, such as inequality of bargaining power between debtor and creditor (so as to dispel the "arms-length" image), or superior knowledge of financial matters on the part of the creditor and reliance on such knowledge by the debtor.[120] The very modest

117. 655 P.2d 1125, 1130-31 (Utah 1982).

118. *Id.* at 1130.

119. *See, e.g.,* Hooper v. Barnett Bank of West Florida, 474 So.2d 1253, 1257 (Fla. App. 1985); Kurth v. Van Horn, 380 N.W.2d 693, 695-96 (Iowa 1986); Denison State Bank v. Madeira, 230 Kan. 684, —, 640 P.2d 1235, 1241 (1982); Stone v. Davis, 66 Ohio St.2d 74, —, 419 N.E.2d 1094, 1097-98, *cert. denied,* 454 U.S. 1081 (1981). *See also,* Annot., *Existence of Fiduciary Relationship Between Bank and Depositor or Customer So As To Impose Special Duty of Disclosure Upon Bank,* 70 A.L.R.3d 1344, 1347 (1976).

120. *See, e.g.,* Commercial Cotton Co. v. United California Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) where the California Court of Appeals described the bank-depositor relationship as "quasi-fiduciary" and affirmed an award of punitive damages in the amount of $100,000 on account of the bank's knowing assertion of a nonexistent legal defense to a claim of the depositor. The court described the salient factors of the bank-depositor relationship as follows:

> A depositor in a noninterest-bearing checking account, except for state or federal regulatory

success with this particular theory has been achieved where the facts did suggest some semblance to the classic fiduciary model. In other words, most lender liability situations will not justify use of this theory, but there are unusual cases where the fiduciary model will work.

One of the leading fiduciary duty cases is *Deist v. Wachholz.*[121] In *Deist,* the plaintiff was a widow whose husband had operated a ranch during his lifetime and, at his death, left his spouse with a debt of approximately $200,000 owing to the Farmers Home Administration. The plaintiff, having little financial experience of her own, sought the bank's advice. Defendant Wachholz offered to help her find a buyer for the property. The plaintiff was interested in preserving the agricultural character of the family property and insisted that any prospective buyer give assurances to this effect. One prospective sale in fact fell through because of this condition. Wachholz found another buyer, John Dittman, and negotiated a purchase agreement with him. The agreement allowed restrictions on the use of the property to begin lifting the next year. Unknown to the plaintiff, Wachholz was a silent partner of the purchaser and subsequent sales of portions of the property indicated that the sale price had been very favorable for the purchaser.[122] Wachholz had thus negotiated a favorable deal with terms inconsistent with the plaintiff's expressed wishes and had participated in the benefits of the deal as a silent partner. The plaintiff sued to rescind the transaction or to recover profits gained on account of the breach of fiduciary duty.

Although not itself a lender liability case, the court's discussion of the bank-customer relationship is important. The court acknowledged the general rule that the bank-customer relationship does not as such give rise to fiduciary responsibilities.[123] Existence of a fiduciary duty thus must depend upon proof of a special relationship:

> Where it is alleged [that] a bank has acted as the financial advisor of one of its depositors for many years, and that the latter has relied upon such advice, it is a sufficient allegation that a confidential relationship in regard to financial matters does exist and that, if it is proved, the bank is subject to the rules applying to confidential relations in general.[124]

> oversight, is totally dependent on the banking institution to which it entrusts deposited funds and depends on the bank's honesty 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. The depositor allows the bank to use those funds in exchange for the convenience of not having to conduct transactions in cash and the concomitant security in having the bank safeguard them. The relationship of bank to depositor is at least quasi-fiduciary, and depositors reasonably expect a bank not to claim nonexistent legal defenses to avoid reimbursement when the bank negligently disburses the entrusted funds.
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> 163 Cal. App. 3d at 516, 209 Cal. Rptr. at 554.

See also Hutson v. Wenatchee Fed. Sav. & Loan Ass'n, 22 Wash. App. 91, —, 588 P.2d 1192, 1199 (1978).

121. 678 P.2d 188 (Mont. 1984).

122. *Id.* at 190-92.

123. *Id.* at 193.

124. *Id.* (*quoting* Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 64 P.2d 101 (1937)). *See also* Fridenmaker v. Valley Nat'l Bank of Arizona, 23 Ariz. App. 565, 534 P.2d 1064 (1975); Mills County State Bank v. Fisher, 282 N.W.2d 712, 716 (Iowa 1979); Pigg v. Robertson, 549 S.W.2d 597

The court concluded that there was substantial evidence to establish that the relationship between the plaintiff and the *bank* was more than a simple debtor-creditor relationship.[125] The plaintiff and her husband had dealt with the bank for twenty-four years prior to his death. Both the plaintiff and her husband had imposed trust and confidence in the bank's president. The bank's president acted as an advisor after the death of the husband. This was sufficient to establish a fiduciary duty on the part of the bank.

The court then concluded that this duty extended to officers of the bank, here Wachholz, with respect to the plaintiff's financial matters, including the negotiation of the sale of the ranch.[126] With recognition of a duty owed by Wachholz, the fact of his nondisclosure of material facts in connection with the transaction became a breach of that duty. The court stated that Wachholz was not prohibited from making a profit, but he was required to disclose "fairly and honestly all the information which might be presumed to have influenced her in the transaction."[127]

The chief advantage of the fiduciary duty theory, of course, lies in the remedies available to the aggrieved plaintiff. The plaintiff may seek damages for the breach, restitution of the property unlawfully gained through the breach of duty, imposition of a constructive trust on the proceeds of trust property, or such other equitable relief as appears appropriate under the circumstances.[128] In *Deist*, the plaintiff sought to recover rent for the period the defendant occupied the land together with the profits gained from the transaction. The court affirmed the judgment for rent and remanded the case for additional findings on the present value of the profits because the defendants themselves had not received the entire payment in the resale of the property.[129]

One fiduciary duty case in the debtor-creditor context is *Peoples Bank & Trust Co. of Cedar Rapids v. Lala*.[130] The debtors were a husband and wife whose individual and farm corporate debt totalled over $675,000. When it became apparent that the indebtedness was undersecured, the bank sought additional collateral from the debtors. At this time, the husband was hospitalized in the coronary care unit. While in the hospital, he and his wife signed a $100,000 note on their homestead. No new consideration was given for the new note and mortgage.[131]

Subsequently, the bank brought an action to collect on the notes and foreclose on the mortgages. The debtors asserted several defenses, including breach of fiduciary duty. In connection with the fiduciary duty defenses, the

(Mo. App. 1977); Annot., *supra* note 119 (existence of special circumstances of fiduciary relationship between bank and depositor or customer so as to impose special duty of disclosure upon bank).

125. *Deist*, 678 P.2d at 193.

126. *Id.* at 194.

127. *Id.* at 195.

128. *See* RESTATEMENT (SECOND) OF TRUSTS §§ 198, 199, 202 & 205.

129. *Deist*, 678 P.2d at 199.

130. 392 N.W.2d 179 (Iowa App. 1986).

131. *Id.* at 181.

court found that the relationship between the debtors and one Don Ellis, an official of the bank, went beyond the typical arms-length relationship:

> For over 20 years the Lalas had obtained all of their business and personal financing through Ellis. At the same time Ellis and the Lalas were close and trusted personal friends. They did many social things together. Ellis testified he even discussed the Lalas' business investments during social gatherings. There is sufficient evidence that during the past 20 years the Lalas and Ellis had placed special trust and confidence in each other. Therefore, Ellis was in a position to exercise influence over the Lalas and had the duty to act with good faith.[132]

From the discussion thus far, one might well conclude that the bank would be chastised by the court for taking advantage of a very sick man. But this was not the case. The court found that the husband was well aware before and during his hospitalization of the bank's demand for additional security and concluded that his action was knowing and voluntary.[133] The breach of fiduciary duty occurred instead in connection with the obtaining of the wife's signature on the mortgage of the homestead. In light of the bank's position of trust and confidence, it was a breach of duty not to disclose to the wife the effect of the mortgage on the homestead and its impact upon the debtors' equity position.[134] The bank had come to occupy the role of financial advisor to the debtors. This created a conflict of interest because of its other role as creditor. The higher duty of a fiduciary required full disclosure of the conflict and the impact of the mortgage on the debtors' homestead rights. The court therefore reversed the judgment of foreclosure on the debtors' homestead.[135]

Evidence of some infirmity or lack of understanding on the part of the debtor is not sufficient by itself to establish a fiduciary relationship. The fiduciary duty theory is not a covert mechanism for unabashed sympathy by the court. In *Kurth v. Van Horn*,[136] a landlord agreed to help a financially strapped farmer by co-signing a note and granting a mortgage on his own farmland. The landlord, Gerdes, was eighty years old, suffered from poor health, and had spent some time in a nursing home. There was no showing, however, of any mental or physical impairment at the time of the transaction. Shortly after the transaction, Gerdes died. The principal debtor later defaulted. The trustee of the Gerdes Trust sued the bank, alleging fraud and breach of fiduciary duty. Actual and punitive damages and cancellation of the mortgage were demanded. The trial court ruled in favor of the trustee, but the Supreme Court of Iowa reversed. The supreme court held as a matter of law that no fiduciary relationship had been established by the evidence.[137]

In a similar case, the Minnesota Supreme Court affirmed a directed verdict in favor of a bank who had taken a pledge of stock from a widow suffering

132. *Id.* at 186.
133. *Id.* at 187.
134. *Id.* at 188.
135. *Id.* at 191.
136. 380 N.W.2d 693 (Iowa 1986).
137. *Id.* at 698.

from emotional distress and alcoholism.[138] Viewing the evidence most favorably for the widow, the court assumed that her problems were genuine. But it found nothing to establish the existence of a fiduciary relationship between her and the bank. In the absence of an imposition of fiduciary duties, the arms-length model will prevail.

The feeling that the fiduciary model is inappropriate for most debtor-creditor transactions underlies the somewhat "chilly" reception which this theory has received in the courts.[139] Typical is the following from the Second Circuit Court of Appeals:

> [T]he extension of fiduciary principles to [the debtor-creditor] relationship would face serious obstacles, such as arguments that lending relations between banks and large corporations are the product of arms-length bargaining and that it would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table.[140]

Just as the inexperience or infirmity of the debtor will not by itself create a fiduciary relationship, the giving of advice by the lender will likewise be insufficient. In *Umbaugh Pole Bldg. Co., Inc. v. Scott*,[141] the court stated:

> The only basis for the finding of the fiduciary relationship was the association's giving of advice and counseling to the Scotts relevant to their loans and business activities. But here the offering and giving of advice was insufficient to create a fiduciary relationship. While the advice was given in a congenial atmosphere and in a sincere effort to help the Scotts prosper, nevertheless, the advice was given by an institutional lender in a commercial context in which the parties dealt at arms length, each protecting his own interest.

The recognition that debtors and creditors often have conflicting interests militates against the imposition of a fiduciary relationship. The conflicts are resolved through negotiation and agreement, albeit not always from a position of equal bargaining strength. Nonetheless, most debt transactions are knowing and voluntary.

This is particularly the case when the debtor is represented by counsel. In *Fridenmaker v. Valley National Bank of Arizona*,[142] the Arizona Court of Appeals assumed, for purposes of argument, that initially a fiduciary relationship existed between the debtor and the bank. The debtor, however, was represented by counsel in the transaction in question. The court held that the presence and participation of counsel terminated the legal effect of any confidential relationship.[143] A directed verdict in favor of the bank was affirmed by

138. Klein v. First Edina National Bank, 293 Minn. 418, 196 N.W.2d 619 (1972).

139. *See, e.g.*, Faith, Hope and Love, Inc. v. First Alabama Bank of Talladega County, 496 So.2d 708 (Ala. 1986); Bank of Red Bay v. King, 482 So.2d 274 (Ala. 1985); Denison State Bank v. Madeira, 230 Kan. 684, 640 P.2d 1235 (1982); MacKenzie v. Summit Nat'l Bank of St. Paul, 363 N.W.2d 116 (Minn. App. 1985).

140. Weinberger v. Kendrick, 698 F.2d 61, 79 (2d Cir. 1982).

141. 58 Ohio St.2d 282, —, 390 N.E.2d 320, 323 (1979).

142. 23 Ariz. App. 565, 534 P.2d 1064 (1975).

143. *Id.* at —, 534 P.2d at 1071.

the court.

Review of the fiduciary duty cases suggests strongly that, absent special circumstances, the courts will not impose fiduciary duties on lenders. The theory, when appropriate, can be useful because of the expanded range of remedies provided the aggrieved party. In addition, the relatively few reported cases where the theory is successfully presented is probably not a true indication of the value of the theory. When the special circumstances are present, the equities will appear very strongly in favor of the debtor and there would be great incentive for the financial institution to settle such a case quietly. A bank is best advised to stay away from a jury if there is evidence that it has taken advantage of a widow.

FRAUD AND MISREPRESENTATION

When the breakdown of the debtor-creditor relationship occurs for reasons other than simple inability to pay, there are often charges that the real fault lies with the lender, not the debtor. "If only the bank had not misled us, we could have worked through the problems" expresses the sentiments of some disappointed debtors. Naturally, there is often shifting of the blame to avoid or ameliorate the sense of failure. But there are cases where some of the blame must be attributed to the lender. When the lender misrepresents its intentions or deceives the debtor, a portion or all of the resulting loss may be shifted to the lender.

Fraud may occur in the debtor-creditor context where the creditor falsely promises to loan funds or to refrain from foreclosure in exchange for action by the debtor which benefits the creditor. Where, for example, the lender induces the debtor to pay most of the proceeds of the current crop to the lender with the understanding that operating money for the following year will be forthcoming, the debtor has a fraud claim if the operating funds are not provided as represented. Note the affinity here with the claim for breach of contract. Fraud in the debtor-creditor context is often based upon an agreement or understanding between the parties. The fraud claim does not seek, at least directly, to enforce the agreement. It seeks to compensate the aggrieved debtor for injuries proximately caused by the creditor's wrongful conduct. By not seeking to enforce an agreement, the debtor at least avoids possible parol evidence or Statute of Frauds problems and gains as well the possibility of the greater damages afforded the successful tort plaintiff.

The Elements of Fraud

The elements of the common law action for fraud or deceit are well established.[144] The South Dakota Supreme Court has stated the elements of fraud

144. Prosser and Keeton state the elements as follows:

1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.

2. Knowledge or belief on the part of the defendant that the representation is false—

as follows:

> To prove fraud there must be a misrepresentation: (1) known to be such (or recklessly conceived) by the party making it; (2) made for the purpose of inducing the other party to act; and (3) relied on to the detriment of the innocent party.[145]

Fraud or misrepresentation in the lender liability context usually involves statements concerning repayment of the loan, forbearance by the creditor, or prospects of future financing.

Illustrative of the factual basis of a lender liability fraud claim is *Production Credit Association v. Halverson*.[146] According to the allegations in the debtor's affidavit, the debtor had been doing business with the PCA since 1972. In 1980, his loan arrangement called for yearly payment of all accrued interest plus 15% of the principal balance. This continued in 1981 and 1982. In November of 1982, the debtor had payments due to both the PCA and Federal Land Bank. He was induced by a PCA official to prepay most of the outstanding balance with the understanding that PCA would provide the funds to make the Land Bank payment on the same terms as before. However, the funds advanced to the debtor for the Land Bank were in fact made under new conditions. Thereafter, he was required to pay the entire principal balance at the end of each year. Because of the changed terms, the debtor suffered financial difficulties, including his inability to repay the 1984 loan.[147] The PCA's suit for a money judgment and repossession of the machinery and equipment was eventually met with a counterclaim sounding in fraud, estoppel, and breach of the covenant of good faith. The Supreme Court of North Dakota held that the allegations of the debtor raised genuine issues of material fact and precluded summary judgment in favor of the PCA.[148]

Probably the most common fact pattern in the fraud context involves the representation that if the debtors pay most of the outstanding principal balance, the lender will provide operating money for the following crop season. In *Johansen v. Production Credit Association of Marshall-Ivanhoe*,[149] the PCA compelled the debtors to sell part of their cattle herd and to pay the proceeds

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> or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element often is given the technical name of "scienter."
>
> 3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.
>
> 4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
>
> 5. Damage to the plaintiff, resulting from such reliance.

W. PROSSER & W.P. KEETON, PROSSER AND KEETON ON THE LAW OF TORTS § 105 at 728 (5th ed. 1984).

145. Sperry Corp. v. Schaeffer, 394 N.W.2d 727, 730 (S.D. 1986). *See also* Empire State Bank v. Varpness, 395 N.W.2d 387, 390 (Minn. App. 1986).

146. 386 N.W.2d 905 (N.D. 1986).

147. *Id.* at 907-08.

148. *Id.* at 908. In a companion case, the North Dakota Supreme Court denied summary judgment for the Federal Land Bank on foreclosure of its real estate mortgage. The debtors raised material issues of fact concerning a confiscatory price defense, administrative forbearance, and the Land Bank's forbearance policy. Federal Land Bank of St. Paul v. Halverson, 392 N.W.2d 77 (N.D. 1986).

149. 378 N.W.2d 59 (Minn. App. 1985).

to reduce the outstanding debt. According to the debtors, they were assured that the PCA would provide future loans if they complied. Later, the debtors cash-leased their land at the insistence of the PCA and paid the proceeds to the PCA. The PCA, however, refused to provide any further credit to the debtors. The debtors originally followed the advice of a "farm credit activist" and sued the PCA in federal court for violations of federal laws. As will be discussed below,[150] this was not a smart tactic and their suit was summarily dismissed by the federal court. The debtors then sued in state court for fraud and misrepresentation. Again, their claims were summarily dismissed. The Minnesota Court of Appeals reversed and held that the state claims were not barred by res judicata and that the allegations were sufficient to withstand summary judgment.[151]

The action for fraud is intended to rectify the unfair inequality of information. One party possesses information concerning the true state of affairs but has misled the other party through misrepresentations or calculated omissions into believing that which is not true.[152] The information is often known only to one party, such as the lender's intentions with respect to the financially troubled debtor. A false communication is actionable because the communicator could have shared the true information but instead chose to mislead in order to gain some additional benefit.

When the communication concerns matters which are not uniquely within the knowledge of one party, the claim for fraud is significantly weakened. In *O'Neill Production Credit Association v. Mellor*,[153] the debtors claimed reliance upon the poor advice of the PCA in working through their financial difficulties. The PCA advised the debtors to sell a portion of their land, to sell cattle at particular times, to hedge cattle prices, and to refrain from other sales of grain. The debtors followed the advice and suffered substantial losses as a result. The Nebraska Supreme Court affirmed a summary judgment in favor of the PCA because the advice, although poor, did not misrepresent any material facts. Predictions of future market conditions were not within the exclusive knowledge of the PCA. It could not be fraud to be in error about the course of future market activity.

The facts of the *Mellor* case suggest, if anything, that the proper claim would have been grounded on duress, not fraud. Advice concerning market conditions is frequently given, and often ignored. But when the advice comes from one who has the power to declare a default and accelerate the debt, it cannot be lightly disregarded. What is suggestive of duress in *Mellor* is that the "advice" actually turned out to be an orderly liquidation, which benefited

150. *See infra* notes 248-54 and accompanying text.

151. For another case involving the allegation of fraud in connection with future financing, *see* O'Neill Production Credit Ass'n v. Putnam Ranches, 210 Neb. 72, 266 N.W.2d 242 (1978).

152. The inequality of information remains out of balance because there is *reliance* on the representation. *See* First Nat'l Bank in Lenox v. Brown, 181 N.W.2d 178, 183 (Iowa 1970). If there has been no reliance, or no reasonable reliance, there is no fraud. *See* Empire State Bank v. Varpness, 395 N.W.2d 387, 390 (Minn. App. 1986).

153. 371 N.W.2d 265 (Neb. 1985).

only the creditor. In other words, the debtor may have been forced to take steps which ordinarily would not have been followed but for the economic vulnerability of the debtor. It is understood that a certain amount of compulsion and even coercion is inherent in the process whenever the debtor is financially distressed. Compulsion or coercion per se should not be actionable in the debtor-creditor context. But when the pressure goes beyond acceptable limits, then recovery of what was involuntarily given up is appropriate.[154]

An example of where the line between acceptable and unacceptable creditor pressure might be drawn is found in *State National Bank v. Farah Mfg. Co.*[155] In *Farah*, the debtor was a financially distressed apparel manufacturer. William Farah had served as CEO for twelve years, but was replaced in 1976 during troubled times for the company. Subsequently, the principal bank creditors of Farah Mfg. provided in the loan agreement with the company that any change in management which any two banks considered to be adverse to the interests of the banks would be an event of default.[156] The apparent reason for this provision was to prevent the return of Farah as CEO. When Farah attempted to regain his position, representatives of the defendant bank and another bank threatened to invoke the provision should Farah be successful. The threat was successful and Farah's return to company management was forestalled until after the company had suffered substantial losses.

Farah Mfg. brought suit against State National Bank for fraud, duress, and interference with its business operations. A jury awarded the company damages in the amount of $18.9 million. On appeal, the court reformed the award by a reduction of just over $300,000 but otherwise affirmed the judgment.[157] The bank claimed on appeal that it could not be liable for fraud because fraud cannot arise from a mere warning of an intention to enforce legal rights.[158] The court, however, held that fraud was established by the making of a representation which the bank knew to be false and which resulted in damage to the company.[159] With respect to the separate claim of duress, the court found liability of the bank because the threat was made in bad faith and for the purpose of furthering its own economic interests.[160] The court stated:

> There is evidence that the loan to [Farah Mfg.] was not in default at the time the warnings were given by the lenders on March 22 and 23. There was then no impaired prospect of repayment but for the perpetuation of [the company's] alleged poor financial condition or perhaps for the possibility of Farah's election as CEO (in view of his past performance). . . .
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> * * * *

154. *See generally* D. Dobbs, Remedies § 10.2 (1973).
155. 678 S.W.2d 661 (Tex. Civ. App. 1984).
156. *Id.* at 667.
157. *Id.* at 699.
158. *Id.* at 681.
159. *Id.* at 682.
160. *Id.* at 685-86.

> [Farah Mfg.] did undertake a new obligation to the lenders under duress. By virtue of the warnings made on March 22 and 23, it became specifically and absolutely obligated not to have Farah elected as CEO. Under the management clause, however, Farah could have been elected. The board had been under no obligation to see that such *would not* occur. In the "event" that it did, then it was the legitimate option of the lenders to determine whether or not it should be viewed as a default. Instead, they chose to issue warnings designed to force the board to elect someone other than Farah.
>
> * * * *
>
> The lenders accrued an unjust benefit merely by their efforts to insure that [Farah Mfg.] would be managed by those who had been "previously approved." They had the power to injure the business and property interests of [Farah Mfg.] upon the issuance of their warnings. The evidence is sufficient that injury was sustained by virtue of the lenders' pressure to have Conroy and others manage [Farah Mfg.] and to have Farah excluded from active management.[161]

The finding of duress supports the award of tort damages resulting therefrom. The recovery is usually in the nature of restitution because duress presumes that the injured party gave up something of value under threat.[162] Consequential damages resulting from the duress are recoverable as well.[163]

The "Softening" of the Elements of Fraud

Fraud in the lender liability area often arises in the context of a failure to keep a promise, particularly a promise of future financing. The prospect of enhanced damages, as compared with damages available in a breach of contract action, makes the fraud theory attractive. But the attraction may be offset by the higher pleading requirements for fraud. A failure to keep a promise is not fraud; it is the making of a promise or representation knowing at the time that it is not true which constitutes fraud. Intent, often difficult to prove, is fundamental to fraud; it is usually irrelevant in a breach of contract claim.

There has been some "softening" in the lender liability area for the relatively high pleading requirements of fraud. This happens particularly where the debtor can successfully combine fraud and fiduciary duty theories. If the debtor can show a fiduciary, or quasi-fiduciary, relationship with the creditor, then failure to meet all of the required elements of fraud can be explained away. In *First National Bank in Lenox v. Brown*,[164] for example, the debtor gave a note to the bank in order to make funds available for a business which the debtor was joining. Unknown to the debtor, the bank had a prior security interest in the business' assets. The bank subsequently applied the funds to its

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161. *Id.* at 686 (emphasis in original).
162. *See* D. DOBBS, REMEDIES § 10.2 (1973).
163. *See, e.g.,* Pecos Construction Co. v. Mortgage Investment Co. of El Paso, 80 N.M. 680, 459 P.2d 842 (1969). The court held that the refusal of the lender to provide the agreed upon financing unless the plaintiff paid an additional $12,000 to an unrelated third party constituted duress and supported an award of damages resulting from the wrongful conduct.
164. 181 N.W.2d 178 (Iowa 1970).

note. When the bank sued on the note, the defense of fraud was asserted. The Supreme Court of Iowa affirmed a judgment in favor of the debtor even though the prior security interest was a matter of public record. The bank argued that the debtor had constructive notice and was thus not deceived. But the court held that satisfaction of all of the fraud elements was not necessary in light of the relationship between the bank and the debtor.[165]

Probably the most significant development in this area has been with the concept of "constructive fraud." This is essentially fraud without the element of intent. As such, it removes one of the principal obstacles to assertion of a fraud claim in the lender liability context. The leading case on constructive fraud is *Barrett v. Bank of America*.[166] In *Barrett*, the debtors had executed two personal guarantees as security for loans with the bank and the Small Business Administration. Shortly after funding the loans, the bank informed the debtors that they were in "technical default" because their net worth did not conform with the bank's requirements. It was suggested that they bring in additional investment by way of sale of stock or merger. As an inducement, a bank officer represented to them that if another company merged with the debtors' business, there would be a release of the personal guarantees. A merger was eventually accomplished with another company, but the guarantees were not released as promised. The new business did not fare well after the merger and the loans went into default. The guarantees were enforced by the SBA against the debtors.[167]

The debtors filed suit against the bank for breach of contract, fraud, infliction of emotional distress, and negligence, based on the bank's failure to keep its promise of release of the guarantees upon the merger. At trial, there was a special jury finding that the promise of the release was made, but not with any intention at the time of not honoring the promise.[168] The trial judge believed that this finding foreclosed any liability on the fraud claim. On appeal, the trial court judgment was reversed because there was evidence to support the debtors' constructive fraud theory. As in the *First National Bank in Lenox v. Brown*[169] case, the court did not require strict compliance with all of the elements of fraud because of the "quasi-fiduciary" nature of the bank-customer relationship.[170] Here, the element of *scienter*, or intent, is not required. That is, the constructive fraud claim may go forward without proof that the defendant bank knew at the time of making the representation that it was false.

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165. The court concluded:

> Here, however, the bank, by agreeing to make the loan without mention of its liens, knowing the purpose for which the funds were sought, and being then aware of existing encumbrances held by it on the property being purchased, inferentially induced defendants to forego making the investigation necessary to acquire knowledge of the true facts.

Id.

166. 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16 (1986).
167. *Id.* at 1365-66, 229 Cal. Rptr. at 17-18.
168. *Id.* at 1367 n.2, 229 Cal. Rptr. at 19 n.2.
169. 181 N.W.2d 178 (Iowa 1970).
170. *Barrett*, 183 Cal. App. 3d at 1369, 229 Cal. Rptr. at 20.

The implications of the *Barrett* case are not yet fully known. Because of the factual context, it would appear that the lender-customer relationship will support a claim for what is in effect a tortious breach of contract. This avoids the Statute of Frauds problems, which often bar these kinds of claims. It provides the possibility of enhanced damages, not available for breach of contract. The characterization of the lender-customer relationship as "quasi-fiduciary" will also foster claims based on bad faith, possibly akin to the development in the insurance industry. What does appear is that traditional contract and tort doctrine no longer provides a "safe harbor" for creditors when faced with a lender liability claim. Creditors must now prepare for the possibility that their words and actions will be scrutinized in court, often before a jury, without the benefit of some of the traditional contract or tort defenses. The creditors should therefore conduct themselves accordingly.

DEBT COLLECTION TORTS

Even in instances where the debt is clearly due and owing, the lender must take care in pursuing collection of the obligation. The zealous pursuit of creditor remedies may give rise to an action by the debtor for invasion of privacy, abuse of process, or intentional infliction of emotional distress. This is particularly a problem where the creditor has turned the matter over to an agency whose *raison d'étre* is the collection of past due obligations. Where the person or entity seeking collection has no interest in the goodwill or reputation of the original creditor, abuses can arise. This problem, in fact, has provided the impetus for federal regulation of collection practices by debt collection agencies.[171]

It must be recognized that the debt collection methods are never going to make debtors happy. When the money was borrowed, both the debtor and the creditor expected that there would be repayment. It was also expected the creditor would use lawful, though possibly unpleasant, means to secure repayment in the event the debtor did not perform voluntarily. The creditor must have the right to pursue collection in a lawful manner. The courts have provided relief when collection practices have gone beyond the bounds of decency

171. Fair Debt Collection Practices Act, 15 U.S.C. §§ 1692 *et seq.* The value of this Act for the average consumer may be questioned. As one commentator recently observed, the disclosure requirements of the Act do not appear to have caused genuine consumer awareness of the statutory rights: "[T]here is a great deal of consumer ignorance of the [Act], and it is of little use if not invoked by consumers who might benefit from its protection." Schulman, *The Effectiveness of the Federal Fair Debt Collection Practices Act (FDCPA)*, 2 BANKR. DEV. J. 171, 178 (1985).

Under the original legislation, attorneys who collected debts on behalf of their clients were not included under the Act. 15 U.S.C.A. § 1692(a)(6)(F) (West 1982). This "attorney exception" was given a narrow interpretation. *See* Ayers, *Beyond Truth-in-Lending—Federal Regulation of Debt Collection*, 16 ST. MARY'S L.J. 329, 352 (1985). For example, the Federal Trade Commission proceeded with an investigation under the Act where a debt collection business appeared to be conducted within the cloak of law firm ownership. XYZ Law Firm v. F.T.C., 525 F. Supp. 1235, 1238 (N.D. Ga. 1981). In 1986, Congress removed the "attorney exception" from the Act. Pub. Law 99-361, 100 Stat. 768 (1986); 15 U.S.C.A. § 1692(a)(6) (West Supp. 1988). Thus, any lawyer or law firm which regularly collects consumer debts, either for a client or as part of a business, is now generally subject to the requirements and penalties of the Act. *See* Bingham & Bonenberger, *Lawyers Beware: Small Change in Collection Act Bodes Big Impact*, 2 COM. L. BULL. 14 (March-April 1987).

or beyond what could reasonably have been expected by the parties at the outset.

A relatively early case recognizing a cause of action for intentional infliction of emotional distress on account of abusive collection practices is *Barnett v. Collection Service Co.*[172] In this case, the debtor was a widow with minor children who owed the sum of $28.75 to a coal company. Her modest wages as a clerk and saleslady in a dry goods store were exempt from execution. The coal company referred the matter to a debt collection agency. The agency sent a series of letters to the debtor, threatening various actions if the debt was not paid. One threat concerned contact of the debtor's employer suggesting "we will bother him until he is so disgusted with you that he will throw you out the back door." Another demanded payment within five days "or we will tie you up tighter than a drum." There were also suggestions that the debtor was essentially a criminal for her failure to pay the debt.[173] The Supreme Court of Iowa held that the evidence presented supported recovery for mental pain and suffering.

Abusive collection efforts may cause in some instances physical injuries. In *Marshall v. United Finance & Thrift Corp.*,[174] the creditor made repeated telephone calls to the debtor's residence. Many of the calls were answered by the debtor's brother and they allegedly had the effect of aggravating his physical infirmities and nervousness. He alleged that he suffered welts, extreme nervousness, loss of appetite, and loss of sleep as a result of the telephone calls. The court held that these allegations presented a triable issue of fact for potential recovery of damages. The decision is a reminder that when the creditor's efforts cross over from legitimate collection of debt to tortious conduct, the creditor is susceptible to the claims suffered by the sensitive plaintiff. The tortfeasor takes the plaintiff "as is."

Probably the most common tort claim in connection with debt collection is invasion of privacy. In *Montgomery Ward v. Shope*,[175] the Supreme Court of South Dakota discussed the requirements for a cause of action for invasion of privacy:

> The gist of the cause of action in privacy cases is wrongful conduct of a personal character resulting in injury to the feelings, without regard to any effect which the publication may have on the injured party's pecuniary interest or his standing in the community. [Citations omitted]. The invasion must be one which would be offensive and objectionable to a reasonable man of ordinary sensibilities.[176]

In *Shope*, the creditor experienced collection difficulties with the account. Normal efforts were ineffective because the debtor routinely did not open his mail, nor did he have a business or home telephone. The creditor contacted

172. 214 Iowa 1303, 242 N.W. 25 (1932).
173. *Id.* at 1305, 242 N.W. at 25.
174. 347 S.W.2d 623 (Tex. Civ. App. 1961).
175. 286 N.W.2d 806 (S.D. 1979).
176. *Id.* at 808.

the debtor's two daughters, leaving messages for him to return their calls. The creditor did reach the debtor by telephone when he was at the local cafe. In the subsequent collection suit, the debtor counterclaimed for invasion of privacy and won a jury verdict for $7,000 actual damages and $5,000 punitive damages. The South Dakota Supreme Court reversed, holding as a matter of law that no actionable invasion of privacy had occurred. The evidence must show a "serious, unreasonable, unwarranted and offensive interference with another's private affairs" to be actionable.[177]

It is common for the lender to request a waiver of certain privacy rights as a condition of extending the credit. That is, the lender often must check references and make inquiries concerning the character of the prospective debtor in order to make an informed judgment on the decision to extend credit. Again, the loss of a certain amount of privacy is assumed in connection with the loan transaction. Once the decision has been made, however, the access of the creditor to the debtor's customers, friends, and relatives may be curtailed in the interests of protecting privacy and reputation.

In *Baldwin v. First National Bank of the Black Hills*,[178] the debtor was in default on a business loan and attempts to cure were rejected by the bank. The bank sued for a money judgment and for possession of the collateral. Before the matter came to trial, the bank wrote to the debtor's customers and stated that the debtor was delinquent on his loan and requested payment of accounts jointly to the bank and the debtor. The South Dakota Supreme Court found the bank's tactics to be unwarranted and reversed the judgment of the trial court, remanding to allow evidence of damage for bad faith collection of a debt, invasion of privacy, and mental anguish.[179]

A claim based on invasion of privacy will inevitably involve judgment concerning the appropriateness of the creditor's behavior and the reasonableness of the debtor's expectations of privacy when in default on a just obligation. There can be no clear guidelines as to when the creditor has gone "too far." How many telephone calls are oppressive or how abusive must the language be to be actionable? The cases range from the relatively minor intrusions, like the *Shope* case discussed above, to the outrageous. Five or six calls to the debtor and two or three calls to the debtor's parents over a period of eleven months was held not to be an actionable invasion of privacy by the Maryland Supreme Court.[180] Tacking a business card to the debtor's apartment door was not outrageous conduct in the opinion of the Oklahoma Supreme Court.[181] Daily telephone calls, amounting to over 100 over a period of five months was sufficient to present an issue for the jury under a Florida collection practices statute.[182] Suggestion by the creditor in telephone calls to

177. *Id.* at 807, 810.
178. 362 N.W.2d 85 (S.D. 1985).
179. *Id.* at 90.
180. Household Finance Corp. v. Bridge, 252 Md. 531, 250 A.2d 878 (1969).
181. Munley v. I.S.C. Financial House, Inc., 584 P.2d 1336 (Okla. 1978).
182. Story v. J.M. Fields, Inc., 343 So.2d 675 (Fla. App. 1977).

the debtor's family that she was engaged in an illicit relationship was held by the Alabama Supreme Court to be an invasion of privacy.[183]

The fact that these cases involve judgment about the impact and the severity of the factual allegations does not, however, insure that the plaintiff will always be able to present a jury issue. In a case involving a counterclaim for intentional infliction of emotional distress, the Supreme Court of Illinois upheld the dismissal of the counterclaim for failure to state a cause of action. In *Public Finance Corp. v. Davis*,[184] the debtor was indebted on a promissory note which was secured by a security interest in the debtor's household goods. The debtor made regular payments until she became unemployed and on public aid. The finance company called the debtor several times weekly, often more than once a day for a period of seven months. Account agents went to the debtor's home frequently. One agent called the debtor at the hospital when her daughter was there for treatment. Another employee induced her to write a check on the condition it would not be processed and then informed an acquaintance of the debtor that she was writing bad checks.

The Illinois Supreme Court held as a matter of law that this conduct was not "of such an extreme and outrageous nature as to constitute a basis for recovery."[185] The court stated:

> A creditor must be given some latitude to pursue reasonable methods of collecting debts even though such methods may result in some inconvenience, embarrassment or annoyance to the debtor. The debtor is protected only from oppressive or outrageous conduct.[186]

The court emphasized that liability was usually predicated upon a prolonged course of extreme methods, not upon single isolated instances of questionable conduct.[187]

Similarly, the Supreme Court of Alabama affirmed a summary judgment in favor of a creditor on an invasion of privacy claim where the debtor was ultimately discharged from his employment on account of his financial problems.[188] The debtor was employed as the minister of education at a Baptist church in Bothan, Alabama. He had become delinquent in his payments to GMAC. A credit representative contacted the minister at the church and requested that he encourage the debtor to make payments on the account. Eventually, discussion of the debtor's financial problems became a church matter and the debtor was discharged by vote of the congregation at a special meeting. The debtor filed an invasion of privacy action against GMAC. The trial court granted summary judgment in favor of GMAC and the supreme court affirmed. According to the supreme court, the appropriate standard for liability for invasion of privacy involves "the wrongful intrusion into one's private activities in such manner as to outrage or cause mental suffering,

183. Norris v. Moskin Stores, Inc., 272 Ala. 174, 132 So.2d 321 (1961).
184. 66 Ill. 2d 85, 360 N.E.2d 765 (1976).
185. *Id.* at —, 360 N.E.2d at 768.
186. *Id.* at —, 360 N.E.2d at 768.
187. *Id.* at —, 360 N.E.2d at 768-69.
188. Hart v. General Motors Acceptance Corp., 437 So.2d 1255 (Ala. 1983).

shame or humiliation to a person of ordinary sensibilities."[189] Because the debtor's allegations failed to meet that legal standard, summary judgment was appropriate.[190]

Several states have now enacted statutory provisions on debt collection activities which supplement the federal legislation. Iowa, for example, has specific legislation restricting the practices which may be utilized in the collection of debts.[191] The restrictions are intended to eliminate many of the abuses arising in the reported cases. Nebraska does not have specific legislation, but has codified a right of privacy which prohibits the intrusion "upon any natural person in his or her place of solitude or seclusion, if the intrusion would be highly offensive to a reasonable person."[192]

In addition to the infliction of emotional harm or the unwarranted invasion of privacy, creditors are subject to tort liability for wrongful interference with the business relationships of debtors. The struggling debtor's customers and suppliers may pose a vulnerability which the unscrupous creditor may wish to exploit. This can occur during the debt collection process if the creditor chooses to apply pressure by "choking off" the cash flow, a tactic which gets the attention of the debtor. This is particularly effective if the creditor is already fully secured because it forces the debtor to pay immediately or face liquidation.

The Eighth Circuit in *In re Knickerbocker*[193] reversed a judgment notwithstanding the verdict and found liability of a creditor for wrongful interference with contracts. The debtors in *Knickerbocker* had attempted to work out their financial difficulties with their principal creditors. After several meetings, the parties agreed to the release of crop proceeds for the purpose of paying the amounts due on the debtors' leases, with the remainder to be applied to bank and Commodity Credit Corporation loans. The proceeds, however, were not released because of the decision of the defendant First National Bank of Olwein not to provide a satisfactory "hold harmless" letter, as previously agreed upon. The inevitable result was the termination of the farmland leases and acceleration of the equipment leases. A representative of the bank told the debtors that "you guys are in such financial trouble, you're going down the tubes." The apparent motive of the bank was to precipitate a default

189. *Id.* at 1256.

190. *See also* Vogel v. W.T. Grant Co., 458 Pa. 124, 327 A.2d 133 (Pa. 1974) (notification to employers and relatives of delinquent accounts did not constitute an actionable invasion of privacy); Hendry v. Conner, 303 Minn. 317, 226 N.W.2d 921 (1975) (without deciding whether an action for invasion of privacy would be recognized in Minnesota, the court held that, in the absence of allegations of continuous harassment by the creditor, the claim was properly dismissed for failure to state a cause of action); Pangello v. Murphy, 243 S.W.2d 496 (Ky. 1951) (no redress for invasion of privacy where the landlord informed the plaintiff in the presence of others that he had removed her belongings from her apartment, that she and her family were dirty and not fit to live in his home).

191. IOWA CODE §§ 537.7101-537.7103 (West 1987). For a description of the debt collection provisions, see Note, *Debt Collection Practices: Iowa Remedies for Abuse of Debtors' Rights*, 68 IOWA L. REV. 753 (1983).

192. REV. STAT. NEBRASKA § 20-203 (1983). *See also* RESTATEMENT (SECOND) OF TORTS §§ 652A & 652B.

193. 827 F.2d 281 (8th Cir. 1987).

and cancellation of the leases and thus move the debtors toward liquidation.[194]

The court concluded that the evidence would support a claim for intentional interference with contracts:

> The jury could have interpreted the subsequent charge-off of the lesser amount and the comment of the [bank] officer that the Knickerbockers were, in any case, "going down the tubes," as indications that [the bank] had decided to liquidate the Knickerbockers' farming operations regardless of their ability to survive if the farmland lease payments were made. Accordingly, the jury could have viewed [the bank's] failure to provide the hold harmless letter to [the grain elevator], and its failure to pay the landlords as agreed, as calculated steps designed to put the Knickerbockers out of business.
>
> We therefore cannot agree with the court below that the jury was presented with insufficient evidence from which it reasonably could conclude that [the bank] possessed the requisite intent to interfere with the Knickerbockers' contracts with their landlords when [the bank] refused to pay the landlords as agreed.[195]

Although the wrong appears to be grounded on the bank's failure to abide by its agreement in the workout, the use of the tort claim for interference with contract allowed the debtors to recover tort damages, which in this case included $100,000 in punitive damages. The case poses a warning to creditors who utilize their position to control all of the debtor's business relationships and thereby pressure the debtor for payment.

The debt collection tort cases mark the limits of acceptable creditor behavior in the collection process. As long as the boundaries are fashioned with the understanding that the creditor is entitled to seek payment and that the debtor has given up some measure of privacy by requesting and receiving the creditor's money, there is little risk for the creditor. Creditors are entitled to use the lawful processes, both formal and informal, to collect obligations. They may not abuse that process nor deliberately cause harm to debtors.

THE IMPACT OF FEDERAL LEGISLATION

The foregoing survey of cases in the lender liability area has focused on development of traditional state law doctrine imposing certain duties on lenders during the course of the relationship with the debtor. There has been some legislative reaction, as noted, to the case law developments, but the chief initiative has remained with the litigants in the state courts. The survey must now turn to developments in federal law relating to lender liability. Although the law relating to lender practices and obligations might be viewed as a matter of local concern for the states, it must be remembered that one of the major lenders, particularly in the area of farm credit, is the federal government. Moreover, certain federal legislation offers promising grounds for assertion of claims against lenders. Although it is fair to say that Congress did not have

194. *Id.* at 286-87.
195. *Id.* at 287-88.

financially distressed debtors in mind when enacting the legislation, the statutes, like the common law theories surveyed above, have expanded in the federal courts through application to lender practices.

RICO

At first glance an unlikely candidate for the protection of parties involved in commercial lending relationships, the civil liability provisions of the Racketeer Influenced and Corrupt Organizations Act (RICO)[196] have proven to be attractive for the assertion of claims against lenders. RICO was originally intended by Congress to curtail the activities of organized crime. It describes certain state criminal law offenses as "racketeering activity"[197] and prohibits, *inter alia*, the operation of an enterprise through "a pattern of racketeering activity."[198] The definition of "racketeering activity" includes extortionate credit transactions and mail fraud. By focusing on *activities* associated with, but not limited to, organized crime, the Act could cover a greater range of *actors* than those who made racketeering their principal occupation. The possibility for an expansive application was encouraged by the generous civil liability provisions. In addition to the criminal penalties for violation of the Act, Congress included a provision for recovery of treble damages and attorney's fees for those injured by racketeering activity.[199]

Initially, many federal courts sought to curb a perceived loophole, unintended by Congress, by restricting the civil damage actions to such instances where the defendants had actually been convicted on criminal charges.[200] The United States Supreme Court, however, rejected this judicial gloss on the statute and allowed civil RICO suits to proceed without first alleging a criminal conviction for one or more of the predicate "racketeering" activities. In *Sedima, S.P.R.L. v. Imrex Co., Inc.*,[201] a Belgian corporation sued a joint venturer New York corporation and two of its officers under the civil liability provisions of RICO, alleging the predicate acts of mail and wire fraud. The district court dismissed the suit because there had been no criminal convictions and the Second Circuit Court of Appeals affirmed. The Supreme Court reversed, holding that there was no statutory prerequisite of a prior criminal conviction nor a statutory requirement that the plaintiff show a "racketeering injury" distinct from the injury caused by the predicate acts themselves.[202] The plaintiff must show violation by the defendant of at least one of the predi-

196. 18 U.S.C. §§ 1961-1968.
197. 18 U.S.C. § 1961(1).
198. 18 U.S.C. § 1962.
199. 18 U.S.C. § 1964(c) provides:

> Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

200. *See, e.g.*, Sedima, S.P.R.L. v. Imrex Co., 748 F.2d 482 (2d Cir. 1984), *rev'd*, 473 U.S. 479 (1985); Berstein v. Bank Leumi Le-Israel B.M., 598 F. Supp. 922 (E.D. Pa. 1984), *vacated*, 772 F.2d 893 (3d Cir. 1985).
201. 473 U.S. 479 (1985).
202. *Id.* at —, 105 S. Ct. at 3284.

cate acts and the defendant must conduct an *enterprise* through a *pattern* of "*racketeering activity*." The Court recognized that most civil RICO actions were not directed at "mobsters" but instead at "respected and legitimate enterprises."[203] Nevertheless, the Court believed this problem, if indeed it is a problem, would have to be remedied by Congress, not through judicial rewriting of the statute.

The prospect of jurisdiction in the federal courts, treble damages, and attorney's fees make the allegation of fraud under RICO an attractive alternative to suit or counterclaim in the state courts. As noted by the Supreme Court, the second largest group of civil RICO claims involves allegations of common law fraud in the commercial and business context. Indeed, the companion case to *Sedima* was a lender liability case: *American National Bank & Trust Co. v. Haroco, Inc.*[204] In *Haroco*, the plaintiffs alleged that the defendant bank and several of its officers had fraudulently charged excessive interest rates on loans. The fraud, it was alleged, was carried out through the mails and constituted a pattern of racketeering activity by which the defendants conducted, or participated in the conduct of the bank. The damages suffered were limited to the excessive interest rates charged. The district court, as in *Sedima*, dismissed the complaint for failure to state a claim. The Seventh Circuit Court of Appeals, however, reversed. The Supreme Court upheld this ruling for the reasons stated in the *Sedima* opinion. This decision thereby confirmed the potential of civil RICO as a vehicle for asserting fraud claims against creditors.[205]

Subsequent to *Sedima* and *Haroco*, the federal courts have considered lender liability claims within the civil RICO context. It is a little early to make a final assessment as to effectiveness of the theory because many of the cases are still at the pleading stage. Nevertheless, there are indications that the civil RICO claim can be a useful vehicle for assertion of a fraud claim. In *Wilcox v. First Interstate Bank of Oregon*,[206] the plaintiffs alleged that the bank violated RICO through the use of the mail to charge and collect excessive interest based on deceptive overstatements of the bank's true prime rate. The Ninth Circuit Court of Appeals reversed the summary judgment in favor of the defendant on this claim. The court held that for certain purposes under RICO, the defendant "person" need not be distinct from the "enterprise."[207] The court also discussed the relationship between civil RICO claims and re-

203. *Id.* at —, 105 S. Ct. at 3287. The Court cited the findings of an ABA Task Force which had found that 40% of the civil RICO cases involved securities fraud, 37% involved common law fraud in the commercial or business setting, and only 9% "allegations of criminal activity of a type generally associated with professional criminals." *Id.* at n.16.

204. 473 U.S. 606 (1985).

205. It should be noted that the defendants were granted summary judgment after the case was sent back to the district court. The plaintiffs claimed that the bank had made loans to certain customers at less than the prime rate. This was not disclosed to other customers who were charged, in effect, a higher "prime" rate. The bank was able to show that the loans made at the lower rate had special or distinguishing circumstances so as to dispel the charge of fraud. *See* Haroco, Inc. v. American Nat'l Bank & Trust Co., 662 F. Supp. 590 (N.D. Ill. 1987).

206. 815 F.2d 522 (9th Cir. 1987).

207. *Id.* at 529.

lated common law claims. The jury had rendered a verdict in favor of the bank on the plaintiff's common law fraud claims. It was therefore argued that the plaintiffs were collaterally estopped from pursuing the civil RICO claim based upon fraud. The Ninth Circuit concluded that because the common law fraud theory involved a higher standard of proof (clear and convincing evidence) than did the civil RICO claim (preponderance of the evidence) the plaintiffs were not collaterally estopped by the adverse jury verdict on the common law claim.[208]

The core of the civil RICO lender liability case is fraud. Factually, it is virtually identical to the fraud cases previously discussed under the heading of Fraud and Misrepresentation. Legally, it is a matter of fitting the allegations into the required elements. The facts of *Morgan v. Bank of Waukegan*[209] are illustrative. In 1978, certain individual defendants induced the plaintiffs through false representations to invest in a series of corporations, to guarantee the loans of these corporations, and to pledge their home as security for these loans. In short, the plaintiffs gave both money and credit to this venture. Later, the defendant bank loaned money to the venture and received guarantees and a security interest in the plaintiffs' home. The loans were in default by 1980. The individual defendants, with the consent of the bank, removed much of the assets of the corporation to the premises of a related corporation. The bank held a foreclosure sale of the remaining assets. Eventually, the bank sought a deficiency from the plaintiffs and commenced an action to gain ownership of the plaintiffs' home. The plaintiffs filed the RICO action in federal court.

As described, the facts could easily form the basis of a fraud claim or counterclaim against the individual defendants and the bank. The individuals were involved in a scheme to defraud the plaintiff investors. The bank allegedly collaborated in this scheme by allowing the individuals to "milk" the assets of the corporations and seeking restitution of the resulting loss from the plaintiffs, not the perpetrators of the loss. The RICO claim is accomplished by inclusion of the allegations that the fraud was conducted through use of the mail and that a pattern of racketeering occurred because the mailings took place over a period of time. The Seventh Circuit Court of Appeals reversed the district court's dismissal of the case and held that a pattern of racketeering activity may be shown by evidence of predicated acts "ongoing over a period of time so that they can fairly be viewed as constituting separate transactions, i.e., 'transactions somewhat separated in time and place.' "[210]

Notwithstanding the Supreme Court decisions in *Sedima* and *Haroco*, there remains resistance in the federal courts to the concept of using the civil enforcement provisions of RICO against legitimate business enterprises. The *Haroco* case provides an example in that, on remand, the district court granted the defendant's motion for summary judgment because there was no evidence

208. *Id.* at 531-32.
209. 804 F.2d 970 (7th Cir. 1986).
210. *Id.* at 975.

of fraud.[211] The Fourth Circuit Court of Appeals termed one RICO counterclaim to forestall enforcement of a guarantee "a patently improper use of RICO."[212] Attempts to challenge various aspects of the farm credit system and the federal reserve system under RICO have met with rejection in the courts.[213] Typical of the resistance is the recurring citation of Justice Marshall's dissent in *Sedima*,[214] which suggests that cases of "ordinary fraud" are best left to well-established state and federal remedies.[215]

The actual effectiveness of the civil RICO fraud claim in lender liability transactions is still uncertain. When more of these cases are actually tried, this question will become clearer. It may be that RICO works better from the pleading standpoint than from the trial standpoint. It has a firm foundation as a pleading tool, with the attendant benefits of federal jurisdiction, treble damages, and attorneys fees. At the very least, a well-pleaded RICO count shifts the settlement posture of the litigation.

Deprivation of Constitutional Rights

As discussed previously in connection with debt collection torts, the enforcement of creditor remedies almost inevitably entails some loss of privacy. This is justified because the borrower in effect waives a measure of autonomy through applying for and receiving credit. To a certain extent, the borrower is able to retain some autonomy by keeping the payments current. Default on the obligation signals a corresponding loss of control. Nevertheless, state and federal law recognize certain limitations on the methods of collection. Underlying these limitations is the notion that the debtor in default has not completely waived all rights. Even the debtor in default is entitled to some minimum level of privacy. In addition, the aggrieved creditor is bound to observe a minimum standard of fairness and decency in its pursuit of the obligation.

The concepts of privacy and fairness, of course, are not exhausted on the state level. These concepts also have deep roots in the Constitution of the United States. It is not surprising therefore that debtors have asserted claims, grounded on privacy and fairness, in terms of constitutional rights. There is both federal statutory and judicial authority for recovery of damages on account of a deprivation of constitutional rights.

Perhaps the most successful federal statutory remedy for debtors has been 42 U.S.C. § 1983, which provides a remedy for deprivation of constitutional rights under color of state law.[216] Section 1983 was part of Civil War legislation intended to afford a civil remedy for those injured by state officials in

211. Haroco, Inc. v. American Nat'l Bank & Trust Co., 662 F. Supp. 590 (N.D. Ill. 1987).
212. NCNB National Bank of North Carolina v. Tiller, 814 F.2d 931, 936 (4th Cir. 1987).
213. *See, e.g.*, Brekke v. Volcker, 652 F. Supp. 651 (D. Mont. 1987); Schroder v. Volcker, 646 F. Supp. 132, 135 (D. Colo. 1986).
214. *Sedima*, 473 U.S. at —, 105 S. Ct. at 3293 (Marshall, J., dissenting).
215. *See* Iden v. Adrian Buckhannon Bank, 661 F. Supp. 234, 239 (N.D. W. Va. 1987), *order aff'd in part, vacated in part*, 841 F.2d 1122 (4th Cir. 1988).
216. 42 U.S.C. § 1983, at the time in question, provided in full:

violation of the Fourteenth Amendment.[217] It appears to have taken on a life of its own and now applies in circumstances ranging far beyond civil rights violations. The statute has been applied in the debtor-creditor context where the creditor uses an unconstitutional statute to collect a valid debt.

The seminal case in this area is *Lugar v. Edmondson Oil Co., Inc.*[218] Lugar was the operator of a truckstop and Edmondson Oil was his supplier. Edmonson Oil sued to collect the account and, in connection with the suit, attached certain of Lugar's property by means of pre-judgment attachment. The procedure for pre-judgment attachment required only an *ex parte* petition from the creditor alleging a belief that the debtor was disposing or might dispose of property in order to defeat his creditors.[219] Pursuant to Edmondson Oil's request, the clerk of the state court issued a writ of attachment. The writ of attachment was executed by the county sheriff, effectively sequestering Lugar's property. Thirty-four days after the sequestration, a state trial dismissed the attachment because Edmondson Oil could not establish the required statutory grounds. Edmondson Oil did prevail, however, in the principal action on the debt and some of Lugar's property was sold in execution of the judgment.

Lugar then brought an action in federal court under 42 U.S.C. § 1983 against Edmondson Oil and its president. The district court held that Edmondson Oil's actions did not constitute state action and dismissed the complaint. The Fourth Circuit affirmed.[220]

The United States Supreme Court reversed, holding that Lugar had stated a cause of action under section 1983. If the debtor may challenge a state debt collection remedy on due process grounds, then any denial of due process may provide the basis for a 1983 action.

> If the creditor-plaintiff violates the debtor-defendant's due process rights by seizing his property in accordance with statutory procedures, there is little or no reason to deny to the latter a cause of action under the federal statute, § 1983, designed to provide judicial redress for just such constitutional violations.[221]

The majority opinion observed that the Congressional purpose in enacting section 1983 was to create a remedy which was as broad as the rights guaranteed by the Fourteenth Amendment.[222]

With respect to the state action requirement, the Court held that the con-

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> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

217. II R. ROTUNDA, J. NOWAK & N. YOUNG, CONSTITUTIONAL LAW: SUBSTANCE AND PROCEDURE §§ 19.13-19.14 (1986). For a discussion of the Civil War legislation, *see* Monroe v. Pape, 365 U.S. 167, 172-187 (1961).

218. 457 U.S. 922 (1982).

219. *Id.* at 924.

220. *Id.* at 925.

221. *Id.* at 934.

222. *Id.*

duct causing the depriving of a federal right must be "fairly attributable" to the state. The Court's prior 1983 cases reflect a two-part analysis of what constitutes "fair attribution." First, the deprivation must be caused by the exercise of a right or privilege created by state law. Second, the party charged with the deprivation must be one who can be fairly said to be a state actor. This person may be one who "has acted together with or has obtained significant aid from state officials."[223] Applying this analysis to the case before it, the Court held that the deprivation was the result of a state statute and that the creditor was a joint participant with state officials in this deprivation.[224]

The establishment of civil liability for use of an unconstitutional debt collection statute poses additional pitfalls for creditors and their attorneys. In *Lugar*, the statute authorizing pre-judgment attachment had not been declared unconstitutional at the time of the suit by Lugar.[225] This leaves creditors to act at their peril. To ameliorate some of this difficulty, the Eighth Circuit, in *Buller v. Buechler*,[226] has recognized a good faith defense to the 1983 action.[227] The parties in the *Buller* case itself, however, may have had a difficult time asserting a good faith defense because the statute in question had been declared unconstitutional by a United States District Court Judge six years before the resort to South Dakota's pre-judgment garnishment statute.[228]

Liability under section 1983 may extend to all parties who participate in the unlawful deprivation of constitutional rights. In *Watertown Equipment Co. v. Norwest Bank Watertown, N.A.*,[229] a 1983 action was brought against Norwest Bank, a vice-president of the bank, and the attorney for the bank. Norwest had for many years extended a line of credit to the debtor. From 1978 through 1982, the debtor experienced significant financial problems and the bank decided to cut off the line of credit. The bank was concerned about the movement of its collateral out of the state to other dealerships owned by the principal shareholder of the debtor. In addition, there was concern about possible concealment of proceeds from sales. The bank consulted its attorney, Thomas Green, regarding the use of South Dakota's pre-judgment attachment statute. Green warned that the statute might be unconstitutional, although in his opinion it was not conclusively so. The bank decided to undertake the attachment and, with the aid of attorney Green, secured a writ of attachment from the county clerk of court. The sheriff arrived at the place of business, told the employees to leave, and secured the building and the bank's collateral

223. *Id.* at 937.
224. *Id.* at 941.
225. *Id.* at 944 (Powell, J., dissenting).
226. 706 F.2d 844 (8th Cir. 1983).
227. The court stated the policy underlying this defense as follows:

> There is a strong public interest in permitting private individuals to rely on presumptively valid state laws and in shielding those citizens from monetary damages when they resort to a legal process which they neither know, nor reasonably should know, is invalid.

Buller, 706 F.2d at 851.

228. *See* Stuckers v. Thomas, 374 F. Supp. 178 (D.S.D. 1974).
229. 830 F.2d 1487 (8th Cir. 1987), *appeal dismissed, cert. denied*, 56 U.S.L.W. 3782 (1988).

by changing the locks. The attachment remained in effect for several months. The bank and the debtor reached a settlement, and the Watertown business apparently closed as a result.[230]

The principal shareholder and the company sued in federal district court under section 1983. The district court granted summary judgment in favor of the defendants. The Eighth Circuit reversed. In its opinion, the South Dakota pre-attachment statute was clearly unconstitutional.[231] The potential for harm to the debtor was not alleviated by any procedural safeguards built into the attachment process. There was a lack of judicial involvement in the issuance of the writ. The clerk of courts issued the writ upon *ex parte* application of the creditor. The indemnity bond required by the statute could not exceed $10,000. This was clearly inadequate to protect the debtor. The attached property had a fair market value of between $275,000 and $300,000. "[E]ven if Watertown Equipment had immediately requested a hearing to contest the attachment, the damages for loss of business and harm to reputation and for attorney's fees would easily have exceeded $10,000."[232] In light of the unconstitutionality of the statute, the defendants were not entitled to a qualified immunity from liability.

The bank and its vice-president also argued that even if the law was clear, they should not be subject to liability because they relied in good faith upon the advice of their attorney. Although the general rule is that immunity is not available if the law was clearly established, there are exceptions for "extraordinary circumstances."[233] The court concluded that such circumstances did not exist in this case. Moreover, the equivocal nature of the attorney's advice gave notice of the risk and would not therefore insulate them from liability.[234]

Attorney Green contended that he should not be liable because he merely advised his client of the possible unconstitutionality and instituted the proceedings at the direction of his client. An attorney is in a better position than the client to know the law and may be liable under section 1983 because he or she caused the proceedings to be instituted.[235] The issue is whether he was acting "under color of state law" in giving the advice and participating in the attachment procedure. The court remanded this issue to the district court, holding this to be a factual question of whether Green "jointly participated" with state officials and thus acted under color of state law.[236] The ultimate outcome on this issue will be of special interest to all attorneys.

All parties who jointly participate in pre-judgment creditor remedies are at risk. A countersuit under section 1983 would almost seem *de rigueur* if the pre-judgment remedy has not already been challenged. Recognizing the difficult position in which this places a creditor who wishes to utilize the full range

230. *Id.* at 1489.
231. *Id.* at 1490.
232. *Id.* at 1494.
233. *Id.* at 1495.
234. *Id.* at 1496.
235. *See* Buller v. Buechler, 706 F.2d 844, 852 (8th Cir. 1983).
236. *Watertown Equipment Co.*, 830 F.2d at 1496.

of creditor remedies provided by state law, the Eighth Circuit Court of Appeals found a qualified immunity for those who acted in good faith.[237] Application of this good faith standard to protect a creditor may be found in *Woodring v. Jennings State Bank*.[238] The bank had sued the plaintiff's husband to collect on five promissory notes executed by the husband alone. The plaintiff was not a party to the notes or the state court proceedings. After initiation of the lawsuit, the bank sought to attach all real and personal property of the husband. The sheriff carried out the writ of attachment and returned an inventory which included property jointly held by the plaintiff and her husband. The husband moved the state court to discharge the attachment. A hearing was held, but no evidence was presented to show that the wife held any interest in the property. The motion to discharge the attachment was denied. The husband then filed a bankruptcy petition, thus staying the state court proceedings. The attachment continued in the property through the time the plaintiff filed a lawsuit against the bank attacking the attachment. The district court concluded that the attachment procedure violated the due process rights of nonparty co-owners. However, because this was a case of first impression in Nebraska, with little authority from any jurisdiction on the rights of nonparty co-owners, the court held that the bank was entitled to a qualified immunity defense based on good faith.[239]

It remains to be seen whether section 1983 will continue as a significant counter-measure for debtors after the state legislatures have completed the necessary curative work on the debt collection statutes. As the right of privacy emerges in its constitutional dimension, the use of state debt collection mechanisms may still raise the issue of deprivation of constitutionally protected rights. There cannot be an attack on post-judgment creditor remedies on their face, but there would appear to be room to argue that certain enforcement mechanisms are unconstitutional as applied in the particular situation.

A related theory of recovery is the assertion of a civil cause of action against *federal officials* who deprive a person of clearly established constitutional rights.[240] Known as *Bivens* actions, the most likely circumstance for application in the lender liability area is where the federal officials are employees or agents of a federal lending agency.[241] Such a claim was asserted by the debtor in *Arcoren v. Peters*.[242] In *Arcoren*, the Farmers Home Administration office received complaints that the debtor had abandoned his cattle and that

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237. Buller v. Buechler, 706 F.2d 844 (8th Cir. 1983).

238. 603 F. Supp. 1060 (D. Neb. 1985).

239. *Id.* at 1070.

240. *See* Bivens v. Six Unknown Agents, 403 U.S. 388 (1971).

241. A cautionary note regarding the status of entities in the Farm Credit System is necessary here. Although these entities have been considered governmental entities for many purpose (*see, e.g.*, Schlake v. Beatrice Production Credit Ass'n, 596 F.2d 278, 281 (8th Cir. 1979)), there has been a conscious effort by Congress to establish a more independent status for members of the Farm Credit System. *See* Farm Credit Amendments Act of 1985, Pub. Law 99-205, 99 Stat. 1678 et seq. *See also* H.R. REP. NO. 425, 99th Cong., 1st Sess., *reprinted in* 1985 U.S. CODE CONG. & ADMIN. NEWS 2587, 2589, 2598.

242. 829 F.2d 671 (8th Cir. 1987).

they were being cared for by others at their expense. The complainants, an uncle and a neighbor of the debtor, requested that FmHA repossess the cattle to relieve them of the financial burden of the cattle's care. FmHA made no independent assessment of the validity of the complaints. Without first notifying the debtor, it repossessed the cattle and sold them at auction. The debtor brought an action in federal court against the FmHA officials for the taking of his property without prior notice or opportunity to be heard.

The district court dismissed the action, concluding that the availability of the FmHA appeals process supplanted any constitutionally-based remedy. The Eighth Circuit reversed this ruling, holding that the administrative remedy did not defeat an action brought directly under the fifth amendment.[243] On remand, the district court dismissed the action on the ground that the defendants had qualified immunity.[244] A three judge panel of the Eighth Circuit reversed,[245] but the district court's decision was affirmed on rehearing by the Eighth Circuit *en banc*. The Eighth Circuit allowed a defense of qualified immunity if the constitutional claim is not "clearly established." "An official is not expected to anticipate the law's development or its possible application to a unique situation."[246] It was recognized, however, that the immunity defense would not avail if the official disregarded "undisputed constitutional guarantees."[247] This is very similar then to the position of defendants in 1983 actions who have acted under color of state law.

Section 1983 and *Bivens* actions offer some prospects for challenge to collection methods, even where the debtor is clearly in default. In addition to framing the challenge in terms of either violation of fundamental principles of fairness or privacy, these theories offer the benefits of jurisdiction in the federal courts. From the creditor's standpoint, these challenges are best avoided through preventive steps, primarily education of officials and loan officers, rather than through assertion of "good faith" or lack of "clearly established" rights in the litigation process.

Other Federal Legislation

One of the ironies which may be seen in this brief survey of federal legislation and lender liability is that the most successful claims stem from legislation which on its face has no apparent connection with commercial lending problems while legislation which more directly affects lending practices has proven to be of little use to debtors. There have been many attempts to state a private right of action for damages on account of alleged violations of the farm credit provisions, but none have been successful. A brief survey will indicate the problems which have not been overcome by debtors' counsel.

243. 770 F.2d 137 (8th Cir. 1985).
244. 627 F. Supp. 1513 (D.S.D. 1986).
245. 811 F.2d 392 (8th Cir. 1987).
246. *Arcoren*, 829 F.2d at 673.
247. *Id.*

In *Aberdeen Production Credit Association v. Jarrett Ranches*,[248] the PCA filed an action in state court seeking foreclosure of security interests in certain real and personal property owned by the debtors. The defendants counterclaimed, *inter alia*, for violation of the regulations and guidelines of the Farm Credit Act of 1971. The case was removed to federal court on the basis of the federal question of whether the Farm Credit Act of 1971 created a private cause of action for suits against the farm credit system.[249] The district court followed the established guidelines of *Cort v. Ash*[250] to determine whether a federal statute confers a private right of action. The court concluded, consistently with other courts, that it did not. There was little in the way of entitlements for borrowers other than certain procedural rights. There was no evidence of any Congressional intent to create a private action. "Because the Farm Credit Act does not proscribe any conduct as unlawful or create specific enforceable rights on behalf of borrowers, there is no support for an implied private cause of action."[251]

The district court, in *Mendel v. Production Credit Association of the Midlands*,[252] rejected a similar attempt to maintain an action for damages for violation of the Farm Credit Act of 1971 and the Farm Credit Amendments Act of 1985. The debtors alleged that the PCA did not comply with the obligation to loan funds at the lowest possible cost; that it did not distribute profits to stockholders; that it did not notify the debtors of its forbearance policy; that it did not follow its policy for lending under stress conditions; and that it failed to inform the debtors of their rights at the time application was made for the loan. The court acknowledged that the legislation created certain rights for borrowers, but it concluded that the appropriate remedy for violation was to require the PCA to comply with the provisions, not to award damages for their violation.[253] The court followed the clear line of decisions rejecting recognition of a private right of action.[254]

It seems reasonably clear that further pursuit of relief under this theory is pointless. The federal courts are always reluctant to grant jurisdiction for litigation of what appears to be state law matters. As noted above, some of this reluctance is evidenced in the civil RICO area as well. Apart from some limited success with civil RICO and utilization of section 1983 or *Bivens* actions

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248. 638 F. Supp. 534 (D.S.D. 1986).

249. *Id.* at 535.

250. 422 U.S. 66, 78 (1975). According to *Cort*, there are four factors to consider: (1) whether the plaintiff is one of a class for whose special benefit the statute was enacted; (2) whether there is any evidence of legislative intent to create a private remedy or to deny one; (3) whether there is a remedy consistent with the underlying purposes of the legislative scheme; and (4) whether the cause of action is one traditionally relegated to state law and of concern primarily to the states so that it would be inappropriate to infer a cause of action based solely on federal law.

251. *Aberdeen Production Credit Ass'n*, 638 F. Supp. at 537.

252. 656 F. Supp. 1212 (D.S.D. 1987).

253. *Mendel*, 656 F. Supp. at 1215.

254. *See, e.g.*, Smith v. Russellville Production Credit Ass'n, 777 F.2d 1544, 1547-48 (11th Cir. 1985); Brekke v. Volcker, 652 F. Supp. 651 (D. Mont. 1987); Creech v. Federal Land Bank of Wichita, 647 F. Supp. 1097, 1101 (D. Colo. 1986); Corum v. Farm Credit Service, 628 F. Supp. 707, 719-20 (D. Minn. 1986); Apple v. Miami Valley Production Credit Ass'n, 614 F. Supp. 119, 121-22 (S.D. Ohio 1985), *aff'd*, 804 F.2d 917 (6th Cir. 1986).

in appropriate circumstances, debtor's counsel is best advised to pursue the state law remedies described in this article.

CONCLUSION

In the great majority of cases, repayment of debt occurs voluntarily. This strongly suggests that the process whereby credit is requested, received, and repaid is essentially a fair one. Any process, however, no matter how fair, will exhibit imperfections. The problems are usually traceable to one or more of the players in the system (sometimes referred to as "the human element"). Underlying a breakdown of the debtor-creditor relationship may be a personality conflict, the desire of a junior level loan officer to establish a reputation for aggressiveness, or the short-sightedness of a creditor who panics at the first sign of trouble. The lender liability cases are intended to curb the abuses and unfair conduct which arise in relatively rare instances. The cases do not represent an attack on the process, but rather a holding of the actors to an accounting for their actions.

Lenders must now expect that the relationship with debtors entails ongoing duties of good faith and reasonable judgment. They should also expect their words and actions to come under scrutiny and should conduct themselves accordingly. Forewarned is forearmed. The lender liability cases can in fact serve to strengthen the system by ensuring that the process remains fair and that it is conducted with a measure of dignity and respect for the interests of others.