THE ROLE OF GOOD FAITH IN LENDER LIABILITY SUITS: RISING STAR OR FADING GADFLY?

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INTRODUCTION

Lender liability has received tremendous attention in the past few years in the media,[1] in legal skills seminars,[2] and in academic literature.[3] The term "lender liability", as used in this context, does not refer to credit risk or debt-equity ratios, but to a lender's exposure to lawsuits brought by commercial borrowers based on a wide range of statutory and common law theories. The current interest in the topic is understandable since six of the ten highest judgments in 1987, all exceeding $50 million, involved lender liability lawsuits.[4] The proliferation of these cases may be linked to the rise in the number of poor performing loans plaguing the banking and savings and loan industry. These problem loans have resulted in an increase in lender control

1. *See, e.g.*, Hyde, *Lender Liability Case Law Builds*, 98 U.S. BANKER 24 (Dec. 1987); Smolker, *Footnote From a Lawyers Journal*, 17 REAL EST. REV. 20 (Winter 1987); Hinefeld, *Now It's Lenders Who Must Beware*, 7 CAL. LAW. 61 (Sept. 1987).

2. Recent seminars addressing lender liability have been sponsored by the Commercial Law League of America on July 11-16, 1987, in Ashville, North Carolina; the American Bar Ass'n, on April 19-20, in New York, New York, and on June 14-15, 1985, in Beverly Hills, California; and the National Business Institute, Inc. on August 16, 1987, in Phoenix, Arizona and August 17, 1987, in Tucson, Arizona.

3. *See, e.g.*, Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411 (1987) (discusses lender liability arising from good faith, excess control, foreclosure, and deceptive trade practices); Ebke & Griffon, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775 (1986) (analyzes the effect of the emerging lender liability theories on commercial transactions); Comment, *Lender Liability For Breach of the Obligation of Good Faith Performance*, 36 EMORY L.J. 917 (1987) (discussing the good faith obligation and rejecting an expansive application of breach of the obligation).

4. *Lender Liability Accounts For 6 of the 10 Highest Judgments in 1987*, II LENDER LIABILITY LAW REP. 2-3 (Aug. 1988). The six lawsuits include: Penthouse Int'l v. Dominion Fed. Sav. & Loan Ass'n, 665 F. Supp. 301 (S.D.N.Y. 1987), *rev'd*, 855 F.2d 963 (2nd Cir. 1988) ($129 million in compensatory damages awarded in bench trial), *cert. denied*, 109 S.Ct. 1639 (1989); Scharenberg v. Continental Ill. Nat'l Bank & Trust Co., No. 87-0238-CIV-DAVIS (S.D. Fla. 1987) ($105 million in compensatory damages awarded in jury trial); FDIC v. W.R. Grace Co., 691 F. Supp. 87 (N.D. Ill. 1987) ($25 million compensatory and $25 million punitive damages allowed in jury trial), *aff'd in part, rev'd in part, remanded*, 77 F.2d 614 (7th Cir. 1989); Conlan v. Wells Fargo Bank, N.A., No. 82,852 (Cal. Super. Ct. Monterey County 1987) ($10 million compensatory and $50 million punitive damages granted in jury trial); Robinson v. Tex. Commerce Bank - McAllen, N.A., No. C-1948-84-D (Tex. Ct. App. 1987) ($9.3 million compensatory and $50 million punitive damages awarded in jury trial); Stanghellini Ranch, Inc. v. Bank of America Nat'l Trust & Sav. Ass'n, No. 35,448 (Cal. Super. Ct. Sutter County 1987) ($20 million compensatory and $30 million punitive damages authorized in jury trial).

over borrowers' business affairs leaving lenders more vulnerable to borrower dissatisfaction.[5]

In what has come to be known as "emerging theories of lender liability,"[6] borrowers rely on both common law principles and statutory law in pursuing claims against lenders. Although the legal arguments are not novel, their invocation to recover damages from lenders as a result of unsuccessful business transactions is a relatively recent trend. "Lender liability theories" may include fraud,[7] duress,[8] intentional interference with contract,[9] intentional interference with corporate governance,[10] and breach of the duty of good faith and fair dealing.[11] Of these theories, good faith and fair dealing is the broadest in scope, and often accompanies other claims.[12]

Lawsuits against lenders based on breach of the implied covenant of good faith arise from a wide variety of scenarios. Borrowers may sue when a bank refuses to advance on a line of credit,[13] accelerates repayment of the debt,[14] or demands early repayment of the debt.[15] Claims of wrongful re-

5. *See Introduction*, 1 EMERGING THEORIES OF LENDER LIABILITY 9 (H. Chaitman ed. 1985).

6. *Id.*

7. *See* State Nat'l Bank of El Paso v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984) (action for fraud may arise from promise which is not intended to be performed); Barrett v. Bank of America N.T. & S.A., 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16 (1986) (relationship of bank to depositor is at least quasi-fiduciary and will support an instruction for constructive fraud). For Arizona cases involving alleged lender fraud, see Walters v. First Fed. Sav. & Loan Ass'n of Phoenix, 131 Ariz. 32, 641 P.2d 235 (1982) (a construction lender will not be charged with special knowledge of construction quality in order to justify a borrower's reliance); Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 64 P.2d 101 (1937) (a debtor enjoys confidential relationship with his bank where he has relied on financial advice for 23 years).

8. *E.g.*, *Farah*, 678 S.W.2d 661 (economic duress or business coercion may exist where a victim is forced to choose between a distasteful or costly situation). *But see* Pleasants v. Home Fed. Sav. & Loan Ass'n, 116 Ariz. 319, 569 P.2d 261 (Ariz. Ct. App. 1977) (no duress where purchasers of real property had reasonable options); Republic Nat'l Life Ins. Co. v. Rudine, 137 Ariz. 62, 668 P.2d 905 (Ct. App. 1983) (asserting one's legal rights does not constitute duress).

9. *E.g.*, Snow v. Western Sav. & Loan Ass'n, 152 Ariz. 27, 730 P.2d 204 (1986) (lender must have reasonable grounds to deny its consent for the sale of borrower's apartment building).

10. *E.g.*, *Farah*, 678 S.W.2d 661 (lender interfered with corporation's inherent right to conduct its own affairs); Melamed v. Lake County Nat'l Bank, 727 F.2d 1399 (6th Cir. 1984) (tortious interference found due to lender's control of borrower's business). *But see* Camelot Ltd. v. Union Mut. Life Ins. Co., 154 Ariz. 330, 742 P.2d 831 (Ariz. Ct. App. 1987) (requiring lender's approval of borrower's management is not excessive interference with corporate governance).

11. *E.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) (good faith used to impose duty on lender to provide notice before refusing to advance funds, although loan agreement gives bank sole discretion); Reid v. Key Bank of Southern Me., Inc., 821 F.2d 9 (1st Cir. 1987) (bank may not capriciously terminate a loan agreement).

12. *E.g.*, Rigby Corp. v. Boatmen's Bank & Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986) (good faith and fraud); Centerre Bank of Kansas City v. Distributor's, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985) (good faith and fraud); Kruse v. Bank of America, 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988) (good faith, fraud, intentional interference with economic advantage), *cert. denied*, 109 S. Ct. 870 (1989).

13. *E.g.*, Skeels v. Universal C.I.T. Credit Corp., 335 F.2d 846 (3rd Cir. 1964) (past assurances of future advances made foreclosure improper); *K.M.C.*, 757 F.2d 752 (notice required before calling demand note); Yankton Prod. Credit Ass'n v. Larson, 219 Neb. 610, 365 N.W.2d 430 (1985) (loan agreement termination must be based on a good faith business judgment).

14. *E.g.*, Brown v. AVEMCO Inc. Corp., 603 F.2d 1367 (9th Cir. 1979) (U.C.C. § 1-208 extended to apply when a creditor chooses to accelerate because the borrower violated a specific provision of security agreement and not only when the creditor feels insecure).

15. *E.g.*, *Reid*, 821 F.2d 9 (must have valid business reason to terminate an agreement); *Centerre*, 705 S.W.2d 42 (improper to impose good faith notice period to a demand note because it would rewrite the agreement).

possession[16] and refusal to accept late payments[17] have also led to charges of breach of good faith. In many cases, the borrower asserts either that the obligation of good faith requires more than honesty in performance, and/or that it restricts conduct allowed by express contract terms.

The role of good faith in lender liability suits is unclear since good faith and the principles underlying it are not uniformly defined. Individual judges and juries may use good faith to interpret loan agreements in ways not originally contemplated by the parties.[18] The potential for factfinder misinterpretation is compounded by conflicting definitions and standards from jurisdiction to jurisdiction. At this time, the Uniform Commercial Code's goal of achieving uniformity throughout the jurisdictions,[19] at least as far as defining good faith is concerned, has not been accomplished.[20]

Lenders often suffer severe consequences as a result of their breach of the covenant of good faith. A claim for bad faith breach of contract can lead to substantial compensatory damages once foreseeable lost profits are factored into the equation.[21] In those jurisdictions that recognize a breach of good faith as an independent tort, punitive awards can greatly exceed the borrower's actual loss.[22]

A party may breach the implied covenant of good faith even though its actions are wholly within the express terms of the contract. If in construing those terms, a court modifies them with its perception of good faith, conduct that does not constitute a technical breach may nevertheless be deemed violative of the implied covenant.

Lenders need to be able to rely on the terms of their loan agreements since lending decisions are based on the risk of repayment which is directly affected by control over the borrower's financial condition and use of funds. Greater control and discretion accorded a lender will reduce the lender's credit risk because it can either curtail the borrower's detrimental activity or quickly terminate the loan relationship. The less risk exposure a lender faces, the lower it can price its services. Accordingly, uncertainty over the effectiveness of a contract term creates an unstable business environment that generally results in higher transaction costs.[23]

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16. *E.g.*, Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983) (required notice of reinstatement of foreclosure provisions); Black v. Peoples Bank Trust Co., 437 So. 2d 26 (Miss. 1983) (question for jury to decide whether creditor's refusal to accept debtor's tender of redemption was reasonable and due to feelings of insecurity).

17. *E.g.*, Sahadi v. Continental Ill. Bank & Trust Co. of Chicago, 706 F.2d 193 (7th Cir. 1983) (remanded to determine if payment dates were material contract provisions justifying lender's decision to accelerate).

18. *See, e.g., Reid*, 821 F.2d 9 (apparent demand note held not to be true demand note); *K.M.C.*, 757 F.2d 752 (imposing notice period on demand note); *AVEMCO*, 603 F.2d 1367 (applying U.C.C. § 1-208 reasonable insecurity test to acceleration for technical default); *Fairco*, 674 P.2d 288 (notice required prior to repossession).

19. U.C.C. § 1-102(c) (1978).

20. *See infra* notes 41-42 and accompanying text.

21. *E.g., K.M.C.*, 757 F.2d 752 ($7.5 million in damages were awarded although the total loan commitment was only $3.5 million).

22. *E.g.*, Commercial Cotton Co., Inc. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) (actual damages of $4,000, and punitive damages of $100,000).

23. *See* Amicus Curiae Brief of the Missouri Bankers Ass'n for Appellant, at 49, Centerre Bank of Kansas City v. Distributor's, Inc., 705 S.W.2d 42 (Mo. App. Ct. 1985), *reprinted in* 2 EMERGING THEORIES OF LENDER LIABILITY 1176, 1283 (H. Chaitman ed. 1985).

Complete and unambiguous loan agreements are the best defense against a borrower's claim of breach of the obligation of good faith. A recent decision from the Second Circuit Court of Appeals in *Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association*[24] may offer hope to beleaguered lenders by holding that courts must focus on the expectations of the parties when interpreting a contract.[25] *Penthouse* supports this Note's conclusion that although the implied obligation of good faith is an ever present obligation, it should not be applied to alter express and reasonable loan agreement terms. Instead, the good faith obligation should be invoked solely to limit the discretionary powers of lenders and to protect the expectations of both the borrower and the lender.[26]

This Note examines the role good faith plays in the commercial lender-borrower relationship. In doing so, it offers some examples of the doctrine's current application and potential application in the future. The focus then turns to the consequences of breaching the covenant of good faith, and why some jurisdictions allow punitive damages while others do not. Finally, this Note summarizes the current status of the law and suggests how a commercial lender may be able to avoid liability for a breach of the covenant of good faith.

WHAT IS GOOD FAITH?

Almost every contract is subject to an implied covenant of good faith.[27] The obligation is recognized in common law,[28] the Uniform Commercial Code Section 1-203[29] and the Restatement (Second) of Contracts Section 205.[30]

Common law definitions of the good faith obligation are nebulous, broad, and typically prohibit either party from injuring the rights of the other in the fulfillment of their agreement.[31] The obligation of good faith and fair dealing limits a party's discretion in performing a contract.[32] It also supplies missing contract terms or defines conduct necessary to comply with

24. 855 F.2d 963 (2d Cir. 1988), *cert. denied*, 109 S. Ct. 1639 (1989).

25. The Second Circuit should be influential in matters involving banking and finance because of the high concentration of financial institutions in New York. *See* Bailey & Barrett, *Court Overturns Big Judgment Against Thrift*, Wall St. J., August 29, 1988, at 2, col.4 (eastern ed.).

26. *See generally* Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369 (1980) (arguing that contractual expectation interest encompasses both promisee's expectations of receiving the promised benefit and promisor's expected opportunity costs).

27. 3 CORBIN ON CONTRACTS § 541, at 97 (1964).

28. Wagenseller v. Scottsdale Memorial Hosp., 147 Ariz. 370, 710 P.2d 1025 (1985) (good faith obligation applies to employment at will contracts). *See also* Burton, *supra* note 26, at 404.

29. "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." U.C.C. § 1-203 (1981).

30. "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

31. *E.g.*, *Wagenseller*, 147 Ariz. at 383, 710 P.2d at 1038. "The covenant requires that neither party do anything that will injure the right of the other to receive the benefits of their agreement." *Id.*

32. Not every act of discretion depriving the other party of its anticipated benefits under the contract will breach the obligation of good faith. If there is a legitimate reason for the breach, good faith is not an issue; the reasonable expectations of the parties determine whether a reason is legitimate. Burton, *supra* note 26, at 373.

the contract.[33]

A different view of good faith regards it as a concept without an independent general meaning but that serves to preclude "a wide range of heterogenous forms of bad faith."[34] Thus, the definition of good faith changes with the facts of the case, granting the courts substantial discretion to dictate business ethics.[35]

The Uniform Commercial Code, drafted to clarify the commercial common law,[36] defines good faith as "honesty in fact."[37] This is a subjective standard of good faith that turns on a party's actual belief at the time of the alleged breach. Under this standard, an honest but mistaken belief causing the lender to feel insecure is sufficient to justify the lender's exercise of its discretion to accelerate a note.[38]

The Uniform Commercial Code also establishes an objective standard of good faith that examines whether reasonable people would believe the conduct is justified.[39] This objective standard, however, applies to transactions between merchants, and for purposes of lender liability, banks are not governed by this definition.[40]

The adoption of the Uniform Commercial Code has not resolved how good faith performance should be measured. There is significant disagreement among legal authorities over whether an objective or subjective standard of good faith should govern contractual performance.[41] Since the

33. The good faith concept originated in Roman law which recognized an informal consensual contract. When disputes arose over the exact obligations of the parties, judges decided what the parties ought to have done in good faith. This meant that the parties were bound not only by the terms they agreed to, but by all the terms that jurists believed were naturally implied in the agreement. *See* Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Commercial Code*, 30 U. CHI. L. REV. 666, 669 (1964) (citing F. LAWSON, A COMMON LAWYER LOOKS AT THE CIVIL LAW 123-25 (1955)).

34. Summers, *"Good" Faith in General Contract Law and The Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 201 (1968). This view was adopted by the court in Tymshare Inc. v. Covell, 727 F.2d 1145, 1152 (D.C. Cir. 1984) (the doctrine of good faith implies an obligation not to engage in a particular form of behavior deemed "bad faith"). *See* Russell Eisenberg's criticism of this approach in Eisenberg, *Good Faith Under the Uniform Commercial Code — A New Look At An Old Problem*, 54 MARQ. L. REV. 1, 8 (1971).

35. Eisenberg, *supra* note 34, at 8.

36. "The underlying purposes and policies of this Act are (a) to simplify, clarify and modernize the law governing commercial transactions." U.C.C. § 1-102(2)(a) (1978).

37. U.C.C. § 1-201(19) (1978).

38. 1 ANDERSON ON THE UNIFORM COMMERCIAL CODE § 1-201:84, at 231 (1981). In early drafts of the Uniform Commercial Code, the general definition included "reasonable commercial standards." The fact that this was deleted prior to the final adoption of the Code further supports the contention that the Code drafters intended a subjective standard. Farnsworth, *supra* note 33, at 673.

39. " 'Good faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." U.C.C. § 2-103(1)(b)(1978).

40. "Merchant" is defined as

> a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill.

U.C.C. § 2-104(1978).

For a case that explicitly makes the distinction between creditor-debtors and merchants see Van Bibber v. Norris, 275 Ind.555, 419 N.E.2d 115 (1981).

41. Farnsworth, *supra* note 33, at 672 (good faith must also include an objective standard, otherwise only knowing and deliberate unfairness, maliciousness, trickery and deceit would be for-

courts fail to uniformly apply good faith to loan agreements,[42] lenders face widely diverging interpretations of the scope of good faith behavior.

Whether the courts employ a subjective or objective standard of good faith will affect the nature of a lawsuit for breach of the covenant of good faith. Under the subjective standard, the borrower has a heavier burden of proof since it is the lender's belief that controls, and not an objective reasonable person standard. Moreover, evidence is often difficult to obtain, and the borrower must convince the factfinder that the lender acted dishonestly.[43]

The objective standard, on the other hand, covers a broader range of bad faith activity, including conduct that appears unfair in addition to being dishonest.[44] What constitutes commercial reasonableness, and consequently good faith behavior, may vary between jurisdictions depending on local business customs.[45] Additionally, a judge or jury has an opportunity to impose its own values in interpreting a particular situation, and thereby may alter or add terms to a loan agreement.[46]

In some situations, however, the practical difference between the objective and subjective standard may be minimal. If, for example, a lender acts honestly in fact, but in an objectively unreasonable manner, it may have a difficult time convincing a jury of its good faith. In other circumstances, the difference between a court adopting a subjective or objective standard can be critical in finding liability.[47]

THE EFFECT OF THE IMPLIED OBLIGATION OF GOOD FAITH ON EXPRESS AGREEMENTS

Good Faith and Discretionary Advances

K.M.C. illustrates how a court may use the obligation of good faith to modify loan terms that it perceives as unfair.[48] In *K.M.C.*, the Sixth Circuit held that Irving Trust violated the obligation of good faith by refusing to advance additional funds under a line of credit when the remaining availabil-

bidden); Burton, *supra* note 26, at 386-87 (test for good faith involves both objective and subjective standards, neither alone being a sufficient guide for evaluating behavior); ANDERSON, *supra* note 38, at 230-31 (the question of good faith is narrowly focused on subjective intent).

42. Cases using the subjective standard include *VanBibber*, 419 N.E.2d 115; Sievert v. First Nat'l Bank in Lakefield, 358 N.W.2d 409 (Minn. Ct. App. 1984); Karner v. Willis, 238 Kan. 246, 710 P.2d 21 (1985); *Rigby*, 713 S.W.2d 517.

Cases using the objective standard include *Reid*, 821 F.2d 9; *K.M.C.*, 757 F.2d 752; *Black*, 437 So. 2d 26.

43. *See Black*, 437 So. 2d at 29 (quoting Universal C.I.T. Credit Corp v. Shepler, 164 Ind. App. 516,521,526, 329 N.E.2d 620,625,626 (1975) (the subjective standard is criticized as unjust to borrowers since the lender might call the debt at any time and require the borrower to prove the nonexistent state of mind of the lender)).

44. *E.g.*, *K.M.C.*, 757 F.2d 752 (if the standard had been the subjective belief of the loan officer, a bad faith breach may not have been found). *See infra* notes 48-55 and accompanying text.

45. *Cf.* Eisenberg, *supra* note 34, at 8. ("It seems unlikely [that the drafters of the Code] would permit large manufacturers in the metropolitan areas to be put at the mercy of rural county judges across the country, or vice versa . . . .").

46. *E.g.*, *K.M.C.*, 757 F.2d 752 at 760-61 (court used reasonable loan officer standard to require notice of refusal to advance funds under a line of credit explicitly stating that advances were at the sole discretion of the bank); *AVEMCO*, 603 F.2d 1367 at 1376 (court imposed reasonable man standard to lender's exercise of acceleration clause due to a technical breach of "due-on-sale" provision).

47. *E.g.*, *K.M.C.*, 757 F.2d 752.

48. *K.M.C.*, 757 F.2d 752.

ity on the line was sufficient to allow the advance.[49] The loan terms granted Irving Trust sole discretion to advance funds.[50] In addition, Irving Trust could require repayment on demand.[51] By ruling that good faith requires a lender to give notice before terminating advances and before demanding repayment,[52] the court's decision diminished the effectiveness of the loan terms.

Irving Trust exercised control over the finances of K.M.C. to the extent that K.M.C. was completely dependent on Irving Trust for its operating capital.[53] This fact, coupled with K.M.C.'s inability to operate without outside financing, led the court to impose a notice requirement on Irving Trust. Under this requirement, absent a valid business reason, a commercial lender must provide its borrower with notice before terminating advances so that the borrower can obtain alternative financing.[54] Without a reasonable notice period, K.M.C. would have been completely at Irving Trust's mercy for its survival. The court found this to be an unreasonable result.[55]

The most problematic aspect of the *K.M.C.* decision, from a lender's point of view, is the imposition of a notice period on the demand provision of the note. The court cited unpersuasive authority to support the notice requirement.[56] First, by likening a demand provision to an acceleration clause, the court relied on Section 1-208 of the Uniform Commercial Code, ignoring the official comment stating that the section does not apply to demand notes. Second, requiring notice before demanding repayment severely restricts the lender's ability to react to a financially troubled borrower. This undermines the very purpose of a demand note which is to give the lender a chance to quickly disassociate itself from a financially troubled borrower before repayment of the note becomes impossible.[57]

Irving Trust contended that the good faith obligation does not require notice before discontinuing financing because such an imposition is contrary to the basis of a demand provision that bestows discretion on lenders.[58] Arguing that good faith only requires that a lender exercise reasonable discre-

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49. *Id.* at 759-60.

50. *Id.* at 759.

51. *Id.*

52. *Id.* at 759-60.

53. K.M.C. deposited all of its receipts in a "blocked account" to which only Irving Trust had access, giving Irving Trust control over K.M.C.'s internal sources of cash as well as its outside financing. *Id.* at 759.

54. *Id.*

55. *Id.* at 759 (citing Wells v. Alexander, 130 N.Y. 642, 29 N.E. 142 (1891)). The *K.M.C.* court invoked common law principles to infer a notice requirement where absence of notice would make the contract unreasonable. The *K.M.C.* court also cited U.C.C. § 2-309 comment 8, which states that "[t]he application of principles of good faith and sound commercial practices normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute arrangement." *Id.* However, § 2-309 is part of Article 2 of the Uniform Commercial Code which applies to transactions between merchants. A commercial bank normally would not meet the definition of merchant. *See supra* note 40.

56. *K.M.C.*, 757 F.2d at 759.

57. The Missouri Court of Appeals in *Centerre*, 705 S.W.2d at 47-48, refused to apply the good faith obligation to demand notes because to do so would add a term to the agreement that the parties had not agreed to, and the borrowers knew when they signed the note that it was payable on demand.

58. *K.M.C.*, 757 F.2d at 759.

tion, Irving Trust observed that its loan officer's subjective good faith belief that K.M.C.'s financial condition was deteriorating was sufficient to justify terminating the relationship according to the terms of the agreement.[59] The court concluded, however, that there is an objective element to good faith, and that in exercising discretion, a loan officer is limited by what a reasonable loan officer would do under the same circumstances.[60] Irving Trust's position was weakened by its inability to justify its insecurity by showing that the day it terminated the loan was substantially different from any other day in the loan relationship.[61]

Consequently, the *K.M.C.* court's application of an objective standard of good faith altered the express terms of a contract. As the court acknowledged, in dicta, if the subjective standard had been adopted, the evidence may have been insufficient to find lack of a valid business justification.[62] By implying reasonable notice terms, however, the court determined how the agreement should have been structured. Since the parties did not negotiate for terms requiring a notice period prior to terminating the loan relationship, Irving Trust was not compensated for the resulting extra credit risk.

Good Faith and Demand Notes

Even in jurisdictions rejecting the *K.M.C.* analysis of a demand note, lenders are still vulnerable to charges of bad faith termination of the loan relationship. For example, the First Circuit in *Reid v. Key Bank of Southern Maine*,[63] held that a lender acts in bad faith when it terminates a borrower's line of credit without a valid business justification.[64] In *Reid*, the bank demanded repayment of the note only three months after extending credit, but could not justify that decision because the borrower's financial position had not changed significantly in the interim.[65] The court acknowledged that good faith does not require reasonable notice prior to requesting repayment of a demand note,[66] but found that this particular demand provision was overridden by other contract terms specifying circumstances that would trigger the bank's discretion to call for repayment.[67] The existence of these explicit default conditions contradicted the bank's claim of absolute discretion

59. *Id.*

60. *Id.* at 761.

61. The Court of Appeals found ample evidence to support a jury determination that a reasonable loan officer would have advanced the funds. A critical factor was that the loan would have been fully secured after the advance. Irving Trust argued that a lender's security is not solely dependent upon the adequacy of collateral but also on the borrower's ability to repay. The court, however, was influenced by the counter argument that a reasonable notice period does not affect the ability to repay when evidence indicates that no loss would be sustained by the lender in case of liquidation. *Id.* at 761-62.

62. *Id.* at 761.

63. 821 F.2d 9 (1st Cir. 1987).

64. *Id.* at 16.

65. A jury could have found evidence of bad faith from the fact that the borrower was not in default, the bank did not complain to the borrower about his conduct, and the bank did not give the borrower notice before terminating his line of credit. *Id.* at 15.

66. This interpretation was mandated by the official comment to U.C.C. § 1-208: "Obviously this section has no application to demand instruments whose very nature permits call at any time with or without reason."

67. *Reid*, 821 F.2d at 14.

to demand repayment.[68] Therefore, since the note was not a true demand note, the obligation of good faith in Uniform Commercial Code Section 1-208 implies reasonable justification before termination.[69]

The result in *Reid* is similar to that in *K.M.C.* because in both cases the failure to provide notice and the lack of a business justification for terminating the relationship resulted in a finding of bad faith. The *Reid* court, however, was more sensitive to the enforcement of express contract terms since the court did not use good faith to modify the demand provision. Instead, the parties themselves drafted a loan agreement whose terms contradicted an intent to create a true demand note. *Reid* invoked the good faith obligation to require fairness in the loan transaction without weakening the underlying tenets of lending decisions or loan maintenance procedures.

Good Faith and Repossession

Courts have also held that the obligation of good faith applies to a lender's repossession of collateral.[70] In *Alaska Statebank v. Fairco*,[71] for example, the Alaska Supreme Court concluded that a bank acted in bad faith when it demanded repayment, closed the borrower's business and repossessed its collateral—all without notice—after the borrower rejected a proposed workout plan.[72] When the bank took action against the collateral, it was clear that the borrower was significantly past due in making payments[73] and that its financial condition was deteriorating.[74]

The *Fairco* court held that the bank was estopped from exercising its rights under the loan agreement since it had both accepted late payments in connection with a prior unconnected loan and agreed to negotiate a workout in the current situation.[75] Unless the bank first notified the lender that it was reinstating its right to repossess, any action to terminate constituted a breach of good faith.[76]

Examining the *Fairco* facts, it appears that the bank did everything in its power to act in good faith while maintaining its security in the debtor's collateral. It tried to negotiate a workout agreement acceptable to both parties, but could not come to an agreement with the borrower. Although contract principles allow past practices to modify performance conditions,[77] it

68. The existence of explicit conditions that would render the note payable on demand means that the bank could only demand repayment under prescribed circumstances. Lenders may call a true demand note at will. There was also evidence of a verbal agreement that the bank could not terminate the loan capriciously. *Id.* at 13-14.

69. The court appears to adopt the objective standard of good faith, although at trial, the jury instructions contained a subjective standard. *Id.* at 15 n.2.

70. *E.g.*, *Skeels*, 335 F.2d 846; *AVEMCO*, 603 F.2d 1367; *Fairco*, 674 P.2d 288.

71. 674 P.2d 288 (Alaska 1983).

72. *Id.* at 293. Workout plans are attempts by lenders and their borrowers to restructure loan terms after it is apparent the borrower cannot perform according to the original loan agreement.

73. The note called for installments due on June 15, September 15, and October 15; the borrower did not make any of these payments. *Id.* at 289-90.

74. *Id.* at 290 n.4.

75. *Id.* at 293.

76. *Id.* at 291.

77. U.C.C. § 1-205(3) states "a course of dealing between parties . . . give[s] particular meaning to and [can] supplement or qualify terms of an agreement." For an example of the principle at common law see *infra* notes 157-61 and accompanying text.

seems unfair to the bank to alter the terms of the note based on the bank's practice of accepting late payments on a separate obligation. Certainly by negotiating a new agreement, the bank reinstated its right to rely on the agreed terms. Perhaps the personal attitude of the loan officer offended the court's sense of fairness and influenced the decision.[78]

Fairco and *K.M.C.* illustrate how courts use good faith to imply additional contract terms to which the lender neither agreed, nor received compensation. The case law accordingly reveals that the obligation of good faith is an expansive and amorphous source of liability for commercial lenders.

LIMITING THE EFFECT OF THE OBLIGATION OF GOOD FAITH

Parties involved in a lawsuit alleging breach of the obligation of good faith should be aware of the Second Circuit's recent decision in *Penthouse International v. Dominion Federal Savings & Loan.*[79] In that case, the Second Circuit held that in construing contract terms, the court's role is to give effect to the expectations of the parties rather than to rewrite contract terms.[80] The court used sweeping language to allow application of this rule beyond the specific facts of the case.[81] Moreover, the contract canons of construction the decision employs restrict the court's power to impose obligations that modify express agreements.[82]

The case arose out of Penthouse's attempt to finance construction of a hotel and casino in Atlantic City.[83] The parties agreed in writing that the loan commitment would expire on March 1, 1984.[84] The deadline passed without Penthouse meeting certain pre-closing conditions in the agreement.[85] Concerned about administrative and cost-control weaknesses in the project, Dominion recommended a construction cost evaluation as well as a replacement of the originating lead lender.[86]

Disagreements over each party's responsibilities under the loan commitment led to delays that caused the loan syndicate to collapse in June, 1984.[87] Penthouse claimed that Dominion's co-lead lender had agreed to modify the unmet pre-closing conditions and had accepted Penthouse's proffered substi-

78. The loan officer was described as conducting himself with an air of self-importance and appeared "charged up" while closing down the store. *Fairco*, 674 P.2d at 290.

79. 855 F.2d 963 (2d Cir. 1988).

80. *Id.* at 976.

81. *E.g.*, "An agreement must be construed in the context of the circumstances under which it was entered into and it must be accorded a rational meaning in keeping with the express general purpose." *Penthouse*, 855 F.2d at 975 (citing Tessmar v. Grosner, 23 N.J. 193, 128 A.2d 467, 471 (1957)). Moreover, "in the guise of construing the terms of an agreement, court[s] will not make a different or better contract than the parties themselves have seen fit to enter into . . . ." *Penthouse*, 855 F.2d at 975 (citing *In re* Community Medical Center, 623 F.2d 864, 866 (3rd Cir. 1980)).

82. "[W]e are not at liberty to construe that agreement in a manner inconsistent with its clear language." *Penthouse*, 855 F.2d at 976.

83. *Id.* at 964-65.

84. Queen City Sav. & Loan, the lead lender, made the original commitment to Penthouse on June 20, 1983. This commitment expired on November 20, 1983. Dominion agreed to participate in the syndication on November 21st. Queen City and Penthouse extended the commitment expiration date to December 1st so that Dominion's participation would be valid. The parties then agreed in a letter that the loan would close no later than March 1, 1984. *Id.* at 965-68.

85. *Id.* at 971.

86. *Id.* at 971-72.

87. *Id.* at 972.

tute performance.[88] Further, Penthouse argued that by insisting on additional pre-closing terms after it could not find other loan participants,[89] Dominion had anticipatorily breached the contract.[90] The trial court agreed with both contentions and awarded Penthouse $129 million in compensatory damages.[91]

The Second Circuit reversed, holding that the commitment expired March 1, 1984, and that any extra demands after that date were irrelevant to a claim of anticipatory breach.[92] Although the parties continued to negotiate after March 1, which may be interpreted as a waiver of the expiration date,[93] in this case there was insufficient evidence to indicate that the parties intended a waiver.[94] The court set forth three guiding principles for construing contract terms: 1) a court should construe a contract in the context of its creation,[95] 2) a court has a duty to enforce the plain words of a contract,[96] and 3) a court may not make a different or better contract than the parties themselves have made.[97] The application of these principles to a claim for breach of the obligation of good faith operates to restrain courts from rewriting contracts. Thus, under the *Penthouse* analysis, the obligation of good faith still has force in interpreting ambiguities or discretionary terms, but will not negate express contract terms that represent the expectations of the parties.

The consequences of altering contract terms can be far-reaching. Modification of the loan conditions impacts not only the lead lender, but all of the participating lenders as well. The *Penthouse* court considered concerns of the Federal Home Loan Bank Board that questioned its ability to supervise loan underwriting and the lenders' abilities to assure prudent participations if lead lenders could unilaterally waive conditions.[98] The *Penthouse* decision supports the contention that lenders must be able to rely on the terms of the loan agreement.

BREACH OF THE OBLIGATION OF GOOD FAITH AS A TORT

Theories Of Tort Liability

In general, awarding compensatory damages for breach of a commer-

88. *Id.* at 973.

89. Dominion agreed to participate up to $35 million even though its legal lending limit was $18.5 million which meant it had to sub-participate the excess $16.5 million to other lenders. *Id.* at 969.

90. "An anticipatory breach of contract is a definitive and unconditional declaration by a party to an executory contract - through word or conduct - that he will not or cannot render the agreed upon performance." *Id.* at 977 (citing Ross Systems v. Linden Dari-Delite, Inc., 35 N.J. 329, 340-41, 173 A.2d 258, 261 (1961)). *See* Summers, *supra* note 34, at 216 (obligation of good faith attaches to contract negotiations).

91. *Penthouse*, 855 F.2d at 974.

92. *Id.* at 977.

93. *See Fairco*, 674 P.2d 288, 292.

94. The parties had let the commitment expire by its own terms once before, and had taken affirmative steps to reinstate it. *Penthouse*, 855 F.2d at 976.

95. *Id.* at 975 (citing *Tessmar*, 23 N.J., at 201, 128 A.2d at 471).

96. *Id.*, 855 F.2d at 975 (citing Korb v. Spray Beach Hotel Co., 24 N.J. Super. 151, 157, 93 A.2d 578, 580 (N.J. Super. Ct. App. Div. 1952)).

97. *Id.* (citing *In re Community Medical Center*, 623 F.2d at 866).

98. *Id.* at 981.

cial contract is considered sufficient recompense to the innocent party and an adequate deterrent for the breaching party.[99] Punitive damages are generally not recoverable for breach of contract unless the conduct constituting the breach is also a tort.[100]

Courts are reluctant to allow tort claims in commercial contract litigation for fear of negative effects on commerce, such as inhibiting commercial contracting and converting routine contract disputes into complicated jury trials.[101] Tort remedies may also encourage a multiplicity of suits and discourage settlement if borrowers believe there is a chance of large punitive awards. Moreover, special policy arguments militate against allowing tort remedies for the breach of a commercial loan contract. For example, the potential for tort remedies may escalate lenders' insurance costs,[102] which in turn will affect the public at large through increased transaction costs, and large jury awards could jeopardize the safety and soundness of financial depository institutions.[103]

Whether courts award compensatory damages or punitive damages for breach of contract depends on the circumstances of the breach.[104] In determining if a tort cause of action exists, some jurisdictions require, as a condition precedent, that there be law imposing a duty on the relationship that exists apart from the contract.[105] In other jurisdictions, maliciousness or wanton disregard of the rights of the other party elevates a breach of contract claim to a tort claim.[106]

Several jurisdictions that do not recognize a tort remedy for breach of the good faith covenant, consider the lender-borrower relationship to be quasi-fiduciary in nature, imposing special duties upon the lender.[107] Breach

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99. 5 CORBIN ON CONTRACTS § 1077 at 438 (1964).

100. RESTATEMENT (SECOND) OF CONTRACTS § 355 at 155 (1979).

101. Quigley v. Pet, Inc., 162 Cal. App. 3d 877, 891, 208 Cal. Rptr. 394, 402 (1984).

102. *Cf.* Moradi-Shalal v. Fireman's Fund Ins. Cos., 46 Cal. 3d 287, 250 Cal. Rptr. 116, 125, 758 P.2d 58, 66 (1988) (court analyzes criticisms of an independent cause of action against insurers by third parties).

103. The district court's award of $129 million in the *Penthouse* case may have resulted in the collapse of Dominion Savings and Loan. *See* Bailey & Barrett, *supra* note 25.

104. CORBIN *supra* note 99, § 1019 at 116.

105. First Nat'l Bank in Libby v. Twombly, 213 Mont. 66, 689 P.2d 1226, 1230 (1984) (breach of good faith is tortious when the duty is imposed by law instead of by contract); *cf.* Aspell v. American Contract Bridge League, 122 Ariz. 399, 402, 595 P.2d 191, 194 (Ariz. Ct. App. 1979) (wrongful suspension is not tortious unless the law protects membership in voluntary associations). In lender liability suits, the question would be whether the law recognizes a special duty between lenders and borrowers.

106. *See* Nat'l Farmers Org., Inc. v. Kinsley Bank, 731 F.2d 1464, 1473 (10th Cir. 1984) (punitive damages are allowed for breach of contract when the independent tort or wrong results in additional injury that justifies punishment of the wrongdoer); *Fairco*, 674 P.2d at 297 (bank's conduct was willful, wanton, outrageous, reckless, and without regard for the plaintiff's interests). *But see* Electronic Sec. Systems Corp. v. Southern Bell Tel. & Tel. Co., 482 So. 2d 518, 519 (Fla. Dist. Ct. App. 1986) (breach of contract cannot be converted into a tort merely by allegations of malice); Hadley v. Southwest Properties, Inc., 116 Ariz. 503, 506-07, 570 P.2d 190, 193-94 (1977) (the maliciousness of an act does not render it unlawful if it is the result of a lawful contract privilege).

107. *E.g.*, *Commercial Cotton*, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554 (bank-depositor relationship is at least quasi-fiduciary). *See also* Baylor v. Jordan, 445 So. 2d 254, 256 (Ala. 1984) (a confidential relationship between a lender and a borrower may arise in special circumstances).

of this quasi-fiduciary duty may lead to an award of punitive damages.[108] Thus, the effect is the same as in jurisdictions recognizing a cause of action in tort.

Courts have been creative in finding ways to punish unethical behavior without adopting a cause of action for the breach of the good faith obligation in tort. California courts, for example, recognize bad faith denial of contract.[109] The California approach limits tort actions arising from breach of contract by requiring a particularly egregious form of bad faith. Thus, California is a leader in developing theories of lender liability. The underlying rationale of the various theories is explored in the following sections.

Special Relationships That Give Rise To Tort Liability

Tort actions and punitive damage awards are common in insurance breach of contract cases. The insurance relationship is characterized by elements of public policy, adhesion, and fiduciary responsibility.[110] The insured typically enters into the relationship for protection and security and not for commercial profit. When the insurer breaches its obligation of good faith by refusing to settle within the policy limits, it is difficult to measure the full extent of harm suffered by the insured since the intangibles he sought from the relationship—protection and security—are difficult to replace.[111] From the insured's perspective, contract damages are therefore inadequate compensation. Moreover, contract damages fail to deter the insurer, who enters the relationship strictly for commercial gain, from breaching its obligation.[112]

Some jurisdictions extend tort remedies for breach of contract beyond the insurance context. In California, for example, the bank-depositor relationship[113] is characterized as quasi-fiduciary.[114] *Commercial Cotton Co. v. United California Bank*,[115] reveals the nature of this relationship. In *Commercial Cotton*, the bank refused to reimburse a depositor after the bank negligently paid on a $4,000 forged check.[116] The California Court of Appeals awarded the depositor $4,000 in compensatory damages and $100,000

108. In *Commercial Cotton*, the appellate court upheld $4,000 in compensatory damages and $100,000 in punitive damages. *Commercial Cotton*, 163 Cal. App. 3d at 513, 209 Cal. Rptr. at 552.

109. Seaman's Direct Buying Serv. Inc. v. Standard Oil Co., 36 Cal. 3d 752, 206 Cal. Rptr. 354, 686 P.2d 1158 (1984). For application of this tort to lender liability see *Kruse*, 202 Cal. App. 3d 38, 248 Cal. Rptr. 217, which overturned a jury verdict for bad faith denial of contract; *see also infra* notes 126-32 and accompanying text.

110. Rawlings v. Apodaca, 151 Ariz. 149, 154, 726 P.2d 565, 570 (1986).

111. *Id.* at 159, 726 P.2d at 575.

112. Contract damages provide no incentive for the insurer not to breach.

> [I]f the only damages an insurer will have to pay upon a judgment of breach are the amounts that it would have owed under the policy plus interest, it has every interest in retaining the money, earning the higher rates of interest on the outside market, and hoping eventually to force the insured into a settlement for less than the policy amount.

Id. (quoting Wallis v. Superior Court, 160 Cal. App. 3d 1109, 1117, 207 Cal. Rptr. 123, 128 (1984)).

113. Courts characterize the relationship between a bank and its depositor as that of a debtor and creditor. Traditionally, the relationship does not impose a fiduciary duty on the bank. Annotation, *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 (1976).

114. *Commercial Cotton*, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554.

115. 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554 (Ct. App. 1985).

116. *Id.* at 514, 209 Cal. Rptr. at 553.

in punitive damages. The court concluded that the public policy concerns that apply in an insurance context also apply in the banking field.[117]

The fiduciary duty in the banking relationship arises from the vital public services the banking industry performs, and from the public's dependence on a bank's honesty and expertise.[118] Similar to an individual seeking insurance coverage, the depositor enters the relationship for the security that banks provide, while it is profit that motivates the bank.[119]

Depositors are, however, distinguishable from commercial borrowers, although a party will often fall into both categories.[120] The public policy concerns creating the fiduciary duty are stronger in the depositor relationship than with the commercial borrower.[121] As a result, the jurisdictions have differing approaches to whether a fiduciary relationship exists between borrower and lender. Missouri refuses to find a fiduciary relationship as a matter of law.[122] In contrast, other jurisdictions treat a possible lender-borrower fiduciary relationship as a question of fact.[123] According to these jurisdictions, there is no duty as a matter of law, but special circumstances may create one.[124]

Even in situations where no special relationship exists, a breach of the good faith obligation may be considered tortious if the effects are particularly unfair. California courts have relied on a new tort of bad faith denial of contract to impose liability on commercial lenders.[125]

Bad Faith Denial of Contract

Under the doctrine of bad faith denial of contract, a party breaches the obligation of good faith by denying the very existence of the underlying contract without an honest belief in the validity of this claim.[126] The creation of this cause of action may have been in response to a serious wrong that did not fit the elements of existing torts.[127]

In the leading case, *Seaman's Direct Buying Service v. Standard Oil*,[128] the California Supreme Court held that tort liability may be incurred when the breaching party seeks to shield itself from liability by denying, in bad

117. *Id.* at 516, 209 Cal. Rptr. at 554.
118. *Id.*
119. *Id.*
120. In their analyses, courts treat both the lender-borrower relationship and the depositor-bank relationship as that of debtor-creditor. Except for the impact on the facts, whether a party is technically a borrower or a depositor seems to make no difference on the legal question of whether the financial institution owes a fiduciary duty. Note the language used in *Reid*, 821 F.2d at 17, and *Stewart*, 49 Ariz. at 44-46, 64 P.2d at 106.
121. For example, commercial borrowers are also motivated by profit and are more likely to possess the ability to negotiate for favorable loan terms and have assistance of counsel than a depositor or consumer borrower.
122. *Centerre*, 705 S.W.2d at 53.
123. *Baylor*, 445 So. 2d 254; *Reid*, 821 F.2d 9, 17; Olmeca, S.A. v. Mfrs. Hanover Trust Co., 629 F.Supp. 214, 223 (S.D.N.Y. 1985).
124. Arizona follows this approach. *See infra* notes 137-42 and accompanying text.
125. *Kruse*, 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (inherent precondition of tort claim for bad faith denial of contract is the existence of an enforceable contract).
126. *Seaman's*, 36 Cal. App. 3d at 769, 206 Cal. Rptr. at 363, 686 P.2d at 1167.
127. *See id.* (citing Jones v Abriani, 169 Ind. App. 556, 580, 350 N.E.2d 635, 650 (1976)).
128. 36 Cal. 3d 752, 206 Cal. Rptr. 354, 686 P2d 1158 (1984).

faith, the existence of the contract.[129] The court did not address whether breach of the implied duty of good faith always gives rise to an action in tort. Instead, the court said that a lender denies the existence of a contract in bad faith when it does not honestly believe in its claim, and threatens a court battle solely to intimidate the borrower.[130] Tort remedies are available because such conduct offends accepted notions of business ethics.[131]

The *Seaman's* court failed to indicate how accepted notions of business ethics should be determined or to establish other guidelines for the application of the tort. As a result, lenders are faced with an undefined new source of liability. A particularly disturbing aspect of the *Seaman's* decision for commercial lenders planning a defense is that a vigorous denial of a contract may lead to a claim for tort damages.[132] Such a consequence deters zealous advocacy by the lender's attorney.

While the *Seaman's* majority shied away from adopting a tort cause of action for breach of the obligation of good faith, Chief Justice Byrd, in dissent, advocated the allowance of such a suit under certain circumstances.[133] The Chief Justice contended that the duty to act in good faith is present in every contract, and the precise nature and extent of the duty in any particular contract depends on both the expectations of the parties and the purpose of the contract.[134] Under her framework, tort remedies for breach of contract should be permitted where the parties' expectations of compensatory damages are undermined (by bad faith denial of contract, for example), or if the possibility of a breach is not reasonably foreseeable.[135] Thus, tort liability would not be imposed for every breach of contract but only for failing to act in good faith in accordance with the expectations of the other party.[136] Since most breaches are foreseeable in commercial contracts, there is little danger of tort remedies resulting from every breach.

THE STATUS OF GOOD FAITH IN ARIZONA

Breach of Good Faith and Tort Remedies in Arizona

Arizona does not allow tort recoveries for breach of the obligation of good faith outside the insurance context.[137] Tort recoveries for breach of the covenant of good faith depend on the existence of a "special relationship"

129. *Id.* at 769, 206 Cal. Rptr. at 363, 686 P.2d at 1167.

130. *Id.*

131. *Id.*

132. *See* Comment, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing In a Noninsurance Commercial Contract Case*, 71 IOWA L. REV. 893, 898 (1986).

133. The Chief Justice berated the court for retreating from its past decisions analyzing the scope of the implied covenant of good faith. *Seaman's*, 36 Cal. 3d at 775 -76, 206 Cal. Rptr. at 367, 686 P.2d at 1171.

134. *Id.* at 777, 206 Cal. Rptr. at 368, 686 P.2d at 1172.

135. A breach is not reasonably foreseeable if the parties agree that a particular act is impermissible or if it is clear from the inception of the relationship that contract damages are inadequate. *Id.* at 779-81, 206 Cal. Rptr. at 369-70, 686 P.2d at 1173-74.

136. *Id.* at 779, 206 Cal. Rptr. at 369, 686 P.2d at 1173.

137. Betterton v. First Interstate Bank of Ariz., 800 F.2d 732, 736 (8th Cir. 1986) (applying Arizona law).

between the contracting parties.[138] The Arizona courts have declined to find a special relationship between the commercial lender and borrower as a matter of law.[139]

A long standing Arizona case suggests, however, that due to the technical and far-reaching nature of modern banking practice, a fiduciary relationship between a depositor and a borrower[140] may arise.[141] The Arizona Supreme Court in *Stewart v. Phoenix National Bank*,[142] acknowledged that this fiduciary relationship exists in certain circumstances. The *Stewart* court held that while the bank-depositor relationship normally does not create fiduciary duties, where a depositor relies on the financial advice of bank officers for 23 years, a confidential relationship may develop.[143] Accordingly, the *Stewart* case illustrates how the specific facts in a lender liability lawsuit may influence the outcome of a case.

The Objective vs. Subjective Standard of Good Faith in Arizona

Arizona courts have not clearly stated whether a subjective or objective standard applies to the breach of good faith. It appears, however, that different standards of measuring good faith are adopted depending on the rights involved. In the context of contractual claims under the Uniform Commercial Code, a commercially reasonable standard is applied,[144] whereas in a tort claim, a subjective standard determines a lender's good faith.[145]

Relying on common law principles in *Snow v. Western Savings and Loan*,[146] the Arizona Supreme Court ruled that an acceleration clause will be enforced if the lender has reasonable grounds to believe that a particular transaction will jeopardize its security.[147] In this case, Western Savings relied on a contract clause precluding the transfer of an apartment building without prior approval.[148] Western Savings sought to employ this clause to extract more favorable terms from potential buyers of the building.[149]

The debtors charged Western Savings with breach of the covenant of

138. *Wagenseller*, 147 Ariz. 370, 385, 710 P.2d 1025, 1040.

139. *Stewart*, 49 Ariz. 34, 64 P.2d 101 (1937).

140. The plaintiff in *Stewart* was both a depositor and borrower of the bank. The action for fraud arose out of a loan transaction. *Id.*

141. *Id.*

142. 49 Ariz. 34, 64 P.2d 101 (1937).

143. The court found the relationship exceeded that of merely debtor and creditor. Bank officers repeatedly stated their friendship for the borrower, who relied on their advice and believed they would not take financial advantage of him. *Id.* at 44-45, 64 P.2d at 106. It seems logical to infer that the greater the borrower's sophistication, or in arms-length transactions with commercial borrowers, the less likely it will be for a court to impose a special duty. Although the courts recognize a special relationship between employers and at-will employees, *Wagenseller*, 147 Ariz. 370, 710 P.2d 1025, commercial borrowers usually possess greater bargaining power.

144. *See, Kersten v. Continental Bank*, 129 Ariz. 44, 628 P.2d 592 (Ariz. Ct. App. 1981) (the borrower alleged that the bank breached the contract by acting in a commercially unreasonable manner. The court avoided the issue of the applicable standard by finding that in this case the behavior was not commercially unreasonable).

145. Snow v. Western Savings & Loan, 152 Ariz. 27, 730 P.2d 204 (1986) (in tort claim of intentional interference with contract, good faith belief in privilege has moral connotations).

146. *Id.*

147. *Id.* at 31, 730 P.2d at 208.

148. *Id.* at 29-30, 730 P.2d at 206-07.

149. *Id.*

good faith (a contract claim) and intentional interference with contract (a tort).[150] As to the first allegation, Western Savings failed to show that the new buyers were unqualified, and thus breached the covenant of good faith by threatening to accelerate without reasonable grounds.[151] The court never explicitly stated whether the lender must have an honest belief or an objectively reasonable belief that its security is imperiled, but the requirement of "reasonable grounds" suggests the latter.

The debtor's second claim in *Snow* was for intentional interference with contract.[152] In Arizona, the subjective standard of good faith is the operative standard for this tort.[153] Thus, the issue was whether Western Savings in good faith believed it was privileged to enforce the due-on-sale clause.[154] The court concluded that in this context, good faith connotes a "moral quality or honesty of purpose," and remanded the case for a determination of this question of fact.[155]

The different nature of the contract and tort claims in *Snow* may explain the conflicting standards of good faith. Intent is not a necessary element of breach of contract, since a contract breach may be inadvertant or willful. An intentional tort, on the other hand, requires a particular state of mind,[156] and consequently, the subjective belief and intent of the actor are elements of the tort.

Interpretation of Contract Terms in Arizona

Arizona courts construe contracts according to the intent of their makers.[157] Although in most cases intent is determined by the four corners of the written contract, a lender's conduct that contradicts written loan terms may modify those terms. The Arizona Supreme Court, in *Darner Motor Sales, Inc. v. Universal Underwriters Insurance Co.*,[158] adopted the position that in interpreting a contract, evidence of negotiations and subsequent con-

150. *Id.* at 32, 730 P.2d at 209.

151. *Id.* at 31, 730 P.2d at 208.

152. The elements of prima facie interference with contract are:
(1) the existence of a valid contractual relationship;
(2) knowledge of the relationship on the part of the interferor;
(3) intentional interference inducing or causing a breach;
(4) resultant damage to the party whose relationship has been disrupted; and
(5) that the defendant acted improperly.
Id. at 34, 730 P.2d at 211.

153. *Id.* at 36, 730 P.2d at 213.

154. A due-on-sale clause allows the secured party to accelerate the debt if the debtor transfers the underlying collateral. A party is not privileged to interfere in a contract relationship if the interference is wrongful or improper as determined by weighing the social importance of the interests involved. *Id.* at 35, 730 P.2d at 212.

155. "A determination of good faith involves an inquiry into the party's motive and purpose as well as actual intent." *Id.* at 36, 730 P.2d 213 (citing Phillipe v. Thomas, 3 Conn. App. 471,474-75, 489 A.2d 1056,1059 (1985)).

156. Intent is directed at the consequences of the action and is distinct from motive which is the reason for desiring certain consequences. PROSSER & KEETON ON TORTS § 8, at 34-35 (5th ed. 1984).

157. The objectives of the canons of contract construction are to ascertain the intentions of the parties by giving words their ordinary meaning, reading the contract as a whole, giving effect to the main purpose of the contract, and interpreting the contract to make it effective and reasonable. Phelps Dodge Corp. v. Brown, 112 Ariz. 179, 540 P.2d 651 (1975).

158. 140 Ariz. 383, 682 P.2d 388 (1984).

duct is relevant to determine the parties' intent to integrate.[159] If the evidence reveals the agreement was not integrated, extrinsic evidence will be admitted in addition to the written contract to prove the actual contract terms.[160] Accordingly, in *Darner*, the court enforced the insurer's verbal representations of coverage that contradicted unambiguous contract terms.[161] Examples of modifying behavior in the lender-borrower context would be a pattern of accepting late payments or verbally waiving a written term.

Courts consider every term within the loan agreement, both independently and in conjunction with the other terms, when interpreting the makers' intentions. Thus, in *Kersten v. Continental Bank*,[162] the Arizona Court of Appeals rejected the lender's assertion that its instrument was a demand note. Demand notes are mature and payable immediately after their execution; note terms that indicated the obligation is not instantaneously mature destroyed any presumption that the parties intended the instrument to be a demand note.[163]

Because Arizona considers the circumstances surrounding the making of the contract when determining its terms, good faith performance is defined by more than the written agreement. In contract claims, Arizona employs commercially reasonable standards of good faith which also create an expanded potential source of lender liability. However, there is no indication that the good faith obligation, itself, will be used to modify the terms of the loan agreement.

AVOIDING LIABILITY FOR GOOD FAITH BREACH OF CONTRACT

The existing case law for breach of the obligation of good faith in lender liability lawsuits is confusing and replete with contradictions. Some jurisdictions require a commercially reasonable belief of insecurity before accelerating a debt or repossessing collateral, while others require only an honest belief of insecurity.[164] Under the rulings of some courts, good faith may require a lender to give notice before exercising a demand provision. In contrast, other courts hold that good faith has no application to demand notes

159. *Id.* at 393, 682 P.2d at 398.

160. *Id.*

161. The Arizona Supreme Court adopted the RESTATEMENT (SECOND) OF CONTRACTS § 211 (1979) which modifies the parole evidence rule when dealing with standardized contracts. *Id.* at 391, 682 P.2d at 396. Although commercial borrowers may be charged with more responsibility and knowledge of the contract than insurance consumers, the court's modern view of parole evidence extends beyond the insurance context to allow the introduction of surrounding circumstances in any contract.

162. 129 Ariz. 44, 628 P.2d 592 (Ariz. Ct. App. 1981).

163. The note terms stated it was payable "on demand, if no demand in 90 days." This means a "demand" was required for the debt to mature. *Id.* at 49, 628 P.2d at 597 (citing Peterson v. Valley Nat'l Bank of Phoenix, 102 Ariz 434, 439, 432 P.2d 446, 451 (1967)); *see also* Bank of Nev. v. United States, 251 F.2d 820 (9th Cir. 1957), *cert denied,* 356 U.S. 938.

164. *Compare Black*, 437 So. 2d 26, 27 (jury must decide whether bank official acted as reasonable person, motivated by good faith in refusing to allow redemption due to feelings of insecurity) and *Van Bibber*, 419 N.E.2d 115 (absence of burden of "reasonable commercial standards" on secured parties reflects recognition that sales transactions are more amenable to establishment of "reasonable commercial standards").

and thus the lender need not give notice.[165] Although the growing number of cases provide a lender with various successful defenses and examples of bad faith conduct to avoid, the different jurisdictional approaches render the lender's task more difficult especially with regard to a multi-state loan.

As a starting point, drafting a comprehensive loan agreement may prevent a claim of bad faith, or if litigation ensues, lead to early dismissal by summary judgment. Although parties may not waive the obligation of good faith, they may indicate how good faith performance will be measured.[166] By clearly indicating their intent, contracting parties discourage a court from later imposing an unfavorable term or questioning their intent. In *Sahadi v. Continental Illinois Bank*,[167] for example,[168] the loan agreement provided that a failure to pay accrued interest by a specified date would justify acceleration of the entire amount outstanding.[169] The bank in *Sahadi* refused a payment that was only one day late and accelerated the note.[170] Although the borrower had technically defaulted, the court remanded the case to determine if the payment date was a material condition of the bank's decision to accelerate.[171] Good faith may not have been an issue if the loan agreement had clearly emphasized the importance of timely payment.

Sahadi and other cases[172] illustrate the importance of thoroughly describing the terms that determine technical breaches so that a third party construing the contract understands exactly what constitutes a material breach and when a lender's insecurity is justified.

In addition, lenders should review all standard loan agreements to ensure that the clauses are in harmony and produce an integrated document. Contractual ambiguities justify judicial interpretation, and conflicting terms may negate important credit safeguards. For example, in *Reid*, the bank effectively negated the demand provision of the note by including additional terms that contradicted the bank's right to demand repayment at will.[173] Lenders may also want to include a provision that specifies which state's law will control to avoid uncertainties regarding the nature and scope of the

165. *Compare K.M.C.*, 757 F.2d 752 (objective element of good faith requires notice period before exercising demand provision of note) with *Reid*, 821 F.2d 9 (U.C.C. § 1-208 requiring notice before termination does not apply to demand notes) and *Centerre*, 705 S.W.2d 42 (holding good faith obligation not applicable to demand notes).

166. U.C.C. § 1-102(3) (1978):

> [T]he effect of provisions of this Act may be varied by agreement, except as otherwise provided by this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

Outside the U.C.C., contracting parties may have even broader freedom to contract. One of the purposes of U.C.C. § 1-102(3) is to avoid interference with the Code's effectiveness by evolutionary changes to the statute. *See* U.C.C. § 1-102 official comment 2.

167. 706 F.2d 193 (7th Cir. 1983).

168. *See also Camelot*, 154 Ariz. 330, 742 P.2d 831 (although the agreement did not specifically prohibit leasing without the lender's consent, the agreement was clear that the current management was a material consideration for lending the money).

169. *Sahadi*, 706 F.2d at 195.

170. *Id.*

171. *Id.* at 200.

172. *E.g.*, *Camelot*, 154 Ariz. 330, 742 P.2d 831; *AVEMCO*, 603 F.2d 1367.

173. *Reid*, 821 F.2d 9.

good faith doctrine.[174]

In order to have a contract enforced as written, commercial lenders should refrain from conduct that contradicts express contract terms. Accommodating a borrower's temporary financial difficulties by accepting late payments or negotiating a workout agreement may indicate that the lender has waived its rights under the agreement.[175] Moreover, conduct indicating the parties' actual intent and expectations are different than those expressed in the contract may affect the interpretation of the written word.[176] Finally, conduct at odds with the lender's internal policies may point to a bad faith motive.[177]

CONCLUSION

The scope of the good faith obligation inherent in every commercial loan agreement is unclear; courts interpret good faith in many different ways. The effect on commercial lenders may depend on whether the jurisdiction applies objective or subjective standards of measurement. Some jurisdictions do not allow good faith to alter contract terms, while others use it to modify express contract terms. The individual fact patterns of a case often is a determinative factor in how a court will interpret the obligation. This has resulted in a confused body of case law and a broadened scope of liability for breach of the covenant of good faith.

While it may appear that good faith has become a "loose cannon of liability"[178] for commercial lenders, before awarding damages based on bad faith, a court should consider the full ramifications of its decision. Past decisions have led to questionable precedents, and may have undermined banking public policy.

Although good faith plays a critical role in limiting a lender's contractual discretion to manipulate the lender-borrower relationship, the purpose of the good faith obligation should be to enforce the expectations of the contracting parties, and not to alter or modify commercial contract terms to which both parties have agreed. Fortunately, courts are recognizing the potential dangers of an expansive obligation. The dramatic *Penthouse* decision, reversing a $129 million judgment against a construction lender, may herald a trend of judicial restraint in lender liability suits.

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174. The RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971) provides that contracting parties may choose the law of the state they want to govern their rights and duties unless the chosen state has no relationship with the parties or the transaction, or unless the application of the chosen state will be contrary to the fundamental policy of the forum state. Arizona courts generally follow the Restatement to determine which jurisdiction's laws apply, and will uphold choice-of-law provisions that comport with the Restatement. *See In re* Estate of Levine, 145 Ariz. 185, 700 P.2d 883 (Ariz. Ct. App. 1985).

175. *E.g., Fairco*, 674 P.2d 288.

176. *E.g., Darner*, 140 Ariz. 383, 682 P.2d 388.

177. *E.g.*, Yankton Prod. Credit Ass'n v. Larson, 219 Neb. 610, 365 N.W.2d 430 (1985) (the lender's own internal policies contradicted its defense that its discretion to lend was absolute).

178. Recent Development, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institution?* 40 VAND. L. REV. 1197 (1987).