

Lender Liability: Should Lenders be Required to Continue to Advance Credit to Marginal Borrowers?

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Commercial lending institutions have faced an increase in problem loans over recent years.¹ At the same time, the courts have expanded the legal theories on which lenders may be held liable for damages incurred by their borrowers.² These decisions have made it increasingly difficult for lenders to use practices to improve or secure their credit position.³ The purpose of this article is, first, to review current legal authority on the issue of liability based upon failure to lend or advance and, second, to suggest some guidelines for lenders to consider before deciding to call a loan due or failing to advance further monies.

Lenders have been held liable for damages to their borrowers for exercising too much control over a debtor's business. In *Barrett v. Bank of America*,⁴ the bank told its borrowers, less than a month after funding a \$400,000 accounts receivable line of credit, that they were in default because they were not in compliance with certain financial ratios required by the bank. A bank loan officer made suggestions as to how plaintiffs could improve the situation, including the possibility of bringing in new investors through a merger. The bank promised that, in the event of a merger, the new company, Coded Communications, would be responsible for the loan and that the plaintiffs would be released from their personal guarantees.⁵

A merger was completed several months later, but the bank never released plaintiffs from their personal guarantees. When Coded Communications defaulted on the loan and went into bankruptcy, the bank demanded that the plaintiffs satisfy their guarantees. The bank assigned its

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1. See Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775-76 (1986).

2. See J. TURNER, UPDATE: RECENT CALIFORNIA LENDER LIABILITY CASES (20th Annual California Bankers Association Bank Counsel Seminar program materials) 33B (1987).

3. See Ebke & Griffin, *supra* note 1, at 775-76.

4. 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16 (1986).

5. *Id.* at 1365, 229 Cal. Rptr. at 18.

collateral to the Small Business Administration ("SBA") on a \$253,000 loan made to plaintiffs, and brought foreclosure proceedings against plaintiffs' residence. Plaintiffs were therefore forced to sell their home and pay the SBA with the proceeds of the sale.⁶

Plaintiffs then sued the bank seeking damages for breach of contract, fraud, constructive fraud, conspiracy to defraud, intentional infliction of emotional distress, and negligence. Plaintiffs' theory was based on the bank's failure to honor its promise to release the plaintiffs' personal guarantees after the companies merged.⁷ The court of appeal reversed the trial court's judgment in favor of the bank based on the trial judge's failure to instruct the jury on constructive fraud. The appellate court stated that, because of a feeling of trust and reliability, plaintiffs shared confidential financial information concerning unfavorable developments in the industry, and plaintiffs relied on the loan officer's advice regarding the merger. In addition, the bank stood to benefit from the merger.⁸

The *Barrett* decision suggests that a fiduciary relationship arises between a lender and its borrowers and guarantors whenever a relationship of confidence and trust exists. The imposition of this duty on lenders restricts a lender's course of action in securing or improving its financial position since it is also required to look out for the interests of its borrowers and guarantors.

The *Barrett* holding followed the decision in *Commercial Cotton Co. v. United California Bank*.⁹ That case involved an action by a bank depositor against the bank arising from the bank's act of debiting the depositor's account for \$4,000 on a check containing unauthorized signatures. The jury awarded the depositor \$4,000 for negligence, \$20,000 for intentional infliction of emotional distress by unjustifiably refusing to reimburse the depositor, and \$100,000 in punitive damages for the bank's breach of the implied covenant of good faith and fair dealing.¹⁰

The court of appeal modified the judgment by striking the award for emotional distress because the evidence did not show that the depositor's injuries were anything other than short-lived.¹¹ The court held that the bank's asserted defense of comparative negligence by the depositor was spurious in that the depositor's failure to discover the error until more than a year after its occurrence took place was after-the-fact and thus did

6. *Id.* at 1366, 229 Cal. Rptr. at 18.

7. *Id.*

8. *Id.* at 1368-69, 229 Cal. Rptr. at 20.

9. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

10. *Id.* at 514, 209 Cal. Rptr. at 551-52.

11. *Id.* at 517, 209 Cal. Rptr. at 555.

not contribute to the bank's act of negligence.¹² The court also held, in support of the award of punitive damages, that the relationship of the bank to its depositor is quasi-fiduciary, with depositors reasonably expecting a bank not to claim nonexistent legal defenses to avoid reimbursement when a bank negligently disburses entrusted funds.¹³ Thus, the theory of a quasi-fiduciary relationship between the bank and its depositor was established creating a higher duty of care by lenders to their customers.

How far though is the lender expected to go? Must it place the interests of its borrowers before its own? The trend has been to impose liability on lenders, often on novel theories, whenever it appears that a lender has wronged a borrower.¹⁴ These theories include wrongful control, domination, economic coercion, bad faith, breach of fiduciary duty, breach of contract, breach of the implied covenant of good faith and fair dealing, duress, interference, fraudulent misrepresentation,¹⁵ as well as liability under the Sherman Anti-Trust Act,¹⁶ the Bank Holding Company Act,¹⁷ the Racketeer Influenced and Corrupt Organization Act (RICO),¹⁸ the Uniform Commercial Code (U.C.C.),¹⁹ the Bankruptcy Code,²⁰ Federal security laws²¹ and wage and tax laws.²²

The increase in lender liability lawsuits may be caused by various factors, including a poor economy and publicity about large judgments. A weak economy causes failing borrowers to sue their banks when the banks call the loans due, insist on changes in the borrower's management, or refuse to continue to extend credit. The weak economy prompts banks to call in loans and refuse to advance credit when they would be less likely to do so in more prosperous times.²³ In addition, with an increase in the number of smaller independent banks with less financial strength than the large financial institutions, some banks cannot afford to continue extending credit to marginal borrowers. Consequently, as circumstances or banking requirements change, many lenders, in order to

12. *Id.* at 515-16, 209 Cal. Rptr. at 553-54.

13. *Id.* at 516, 209 Cal. Rptr. at 554.

14. See Moss, *Borrowers Fight Back With Lender Liability*, A.B.A. J., Mar. 1, 1987, at 65.

15. *Id.*; Ebke & Griffin, *supra* note 1, at 776.

16. 15 U.S.C. §§ 1-7 (1982).

17. 12 U.S.C. §§ 1841-1850 (1982).

18. 18 U.S.C. §§ 1961-1968 (1982).

19. U.C.C. §§ 1-201(19), 1-203, 1-208, 2-309.

20. 11 U.S.C. § 510(c)(1982); *id.* § 547(b) (1982).

21. Securities Act of 1933 § 15, 15 U.S.C. § 770 (1982); Securities Exchange Act of 1934 § 20 (a), 15 U.S.C. § 78t (a) (1982).

22. I.R.C. § 3505 (a), (b) (1982).

23. Moss, *supra* note 14, at 66.

protect their own financial condition, are required to make additional demands or call in their more risky loans.

In *K.M.C. Co. v. Irving Trust*,²⁴ the court of appeal affirmed the trial court's ruling in favor of the borrower, K.M.C. The action involved K.M.C.'s suit against a lender (Irving) for breach of a financing agreement. K.M.C., a wholesale and retail grocery business, entered into a financing agreement in 1979 with Irving, whereby Irving held a security interest in all of K.M.C.'s accounts receivables and inventory and provided K.M.C. with a line of credit up to \$3 million, which was increased one year later to \$3.5 million.²⁵

In 1982, Irving refused to advance \$800,000 requested by K.M.C. This amount would have increased the loan balance to just under the \$3.5 million limit.²⁶ K.M.C. contended that Irving's refusal without prior notice to advance the requested funds breached a duty of good faith performance implied in the agreement and ultimately resulted in the collapse of the company as a viable business entity.²⁷ Irving defended on the grounds that K.M.C. was already in a state of collapse, and that Irving's decision was made in good faith and in the reasonable exercise of its discretion under the agreement.²⁸

Relying on the Uniform Commercial Code,²⁹ the court held that the creditor was under a duty of good faith to notify the debtor of its refusal to lend.³⁰ The court stated that notice would have afforded K.M.C. an opportunity to seek alternative financing, thereby preventing the failure of the business.³¹ The court of appeal, in affirming the trial court's decision, held that there is an implied obligation of good faith imposed on a lender which includes a duty to give notice to a borrower before refusing to advance funds under a financing agreement, and that the lender's power to demand repayment under the financing agreement was subject to this good faith obligation.³²

Another case, currently on appeal before the Court of Appeals for the Ninth Circuit, is *Landes Construction Co. v. Royal Bank*.³³ Landes, the sole shareholder of Landes Construction (the Company), and his

24. 757 F.2d 752 (3d Cir. 1985).

25. *Id.* at 754.

26. *Id.*

27. *Id.*

28. *Id.*

29. U.C.C. § 2-309, comment 8 states that: "the application of principles of good faith and sound commercial practice 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."

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

31. *Id.*

32. *Id.*

33. No. CV-83-5430 PAR (C.D. Cal. 1987) (currently on appeal).

friend, Scheinberg, acquired some commercial real estate for development. Scheinberg was to be responsible for obtaining the necessary financing. They were to split the profits equally, and the Company would bear any losses.³⁴

Scheinberg had been a customer of The Royal Bank of Canada for many years and approached William Neopole at the bank. Landes submitted a written purchase offer providing for \$10 million as a down payment with a \$40 million secured note taken back by the sellers.³⁵

Neopole met with Landes and Scheinberg and told everyone attending the dinner that he thought the property was a good deal and that the bank would lend \$10 million for the project. However, there was no discussion of the terms of the proposed loan and no documents were signed. The next day, Neopole, Scheinberg and Landes met at the property with the sellers. At Neopole's suggestion, Scheinberg renegotiated the timing for the repayment of the \$10 million down payment. When the sellers sought assurances regarding performance, Neopole said that the bank was providing financing. Neopole had also told the sellers that he had broad authority and major responsibility with the bank. A formal purchase agreement was signed showing Landes Construction as the purchaser.³⁶

Thereafter, Scheinberg and Neopole met to renegotiate the terms of the loan. According to Scheinberg, they agreed to an interest rate, bank fees, and that Scheinberg and Landes would guarantee the loan. The bank then advanced the \$1 million on an existing line of credit that Scheinberg had with the bank in the name of his company, Elpat. The money was wired to Landes, and a second advance of \$2 million was later made to Landes in the same manner.³⁷

When the case went to trial, Landes and his company took the position that these advances on Elpat's line of credit were really loans to Landes Construction for the down payment on the property and that the bank had only advanced the money on Elpat's line of credit as a convenience. Landes also argued that this deal had been handled in a manner similar to a prior one involving Landes, Scheinberg, and the bank. In that deal, Neopole had arranged for funds to be advanced through Elpat to a construction company owned by Landes and Scheinberg until the paperwork could be processed on the construction company's own line of credit. Scheinberg and Landes both testified that the \$3 million ad-

34. J. TURNER, *supra* note 2, at 46B.

35. *Id.*

36. *Id.* at 47B.

37. *Id.*

vanced to Elpat was a temporary measure similar to the prior construction project.³⁸

Later that year, Scheinberg had asked the bank for an additional \$20 million. Neopole put together a credit application and forwarded it to the head office in Canada. The head office denied the application because there was no equity invested in the property, no arrangements had been made for permanent financing, and no construction contracts had been signed. After the bank denied the loan, Scheinberg and Landes were unable to find alternative financing. The sellers retained the \$3 million that had already been paid as an option payment.³⁹

Landes Construction then filed suit against the bank for breach of contract. The bank's defense was that it had never committed to loan the company any money and that the only potential plaintiff to make such a claim would be Scheinberg. Even though no documents had been signed between Landes Construction and the bank, the jury awarded the company \$18.5 million in damages.⁴⁰

*Sanchez-Corea v. Bank of America*⁴¹ involved a successful damage action against a bank by a former customer alleging breach of contract, fraud, breach of the implied covenant of good faith and fair dealing, disparagement of credit, interference with prospective economic advantage, promissory estoppel, negligence, and intentional infliction of emotional distress.⁴² Substantial evidence supported a \$1 million compensatory damages award for lost profits resulting from the bank's denial of credit.⁴³ Plaintiff had been in the life safety systems business for ten years. It had an established reputation and a growth in sales from \$180,000 in 1970 to \$1.5 million in 1973. The evidence showed that the business' lack of financial resources to develop further resulted from the bank's own wrongdoing. The jury awarded damages for emotional distress based on the bank's intentional or reckless conduct which it should have known would cause emotional distress, in that the bank officers failed to advise plaintiffs that the bank had determined not to give the business further loans.⁴⁴ The bank misrepresented that further financial assistance would be forthcoming if plaintiffs assigned all their past, present, and future accounts receivable to the bank, but the day after plaintiffs made the assignment, the bank refused the loan.⁴⁵ The jury found

38. *Id.*

39. *Id.*

40. *Id.* at 48B.

41. 38 Cal. 3d 892, 701 P.2d 826, 215 Cal. Rptr. 679 (1985).

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

43. *Id.* at 907-08, 701 P.2d at 836-37, 215 Cal. Rptr. at 689-90.

44. *Id.* at 908, 701 P.2d at 837-38, 215 Cal. Rptr. at 690-91.

45. *Id.* at 908-09, 701 P.2d at 838, 215 Cal. Rptr. at 691.

that the bank had forced the plaintiffs to execute excessive guarantees and security agreements, and that the bank officials had publicly ridiculed plaintiffs, using profanities in their statements. The jury, therefore, also awarded punitive damages based on their finding that the bank acted fraudulently in forcing plaintiffs to make the assignment, knowing that it would not extend further loans.⁴⁶

Another pro-borrower case is *999 v. C.I.T. Corp.*⁴⁷ In that case, the proposed borrower brought an action against a proposed lender alleging breach of agreement to provide financing which resulted in the loss of an opportunity to acquire another corporation.⁴⁸ The district court entered judgment for the proposed borrower.⁴⁹ The court of appeals held that the proposed borrower acted reasonably in refusing financing from the proposed lender where the lender was unjustly conditioning the loan on a \$25,000 per month pre-payment penalty.⁵⁰ The evidence showed that the proposed lender knew or should have known that its conduct in subjecting the proposed borrower to the new condition resulted in the borrower being forced to seek financing elsewhere and endangered the proposed borrower's acquisition of the corporation.⁵¹

In *Shaughnessy v. Mark Twain State Bank*,⁵² a borrower brought an action against a bank, requesting damages based on tort causes of action and breach of contract. The circuit court entered judgment for the bank on the tort claim and for the borrower on the breach of contract claim.⁵³ The court of appeals held that although the borrower had failed to establish the intent to injure element of the tort claim, the bank had breached its contract with the borrower by failing to grant the borrower additional funds from an undisbursed portion of his line of credit and that the bank was obligated, barring default, to fund the borrower on the irrevocable line of credit for which the borrower had paid a one percent commitment fee when the arrangement was established.⁵⁴

In the recent case of *Reid v. Key Bank*,⁵⁵ commercial borrowers brought an action against the bank when it terminated a credit arrangement, variously referred to at trial as a "line of credit" and an "incomplete loan."⁵⁶ From 1976 through 1979, the series of loans had been used

46. *Id.* at 909, 701 P.2d at 838, 215 Cal. Rptr. at 691.

47. 776 F.2d 866 (9th Cir. 1985).

48. *Id.* at 867.

49. *Id.*

50. *Id.* at 871.

51. *Id.* at 872.

52. 715 S.W.2d 944 (Mo. Ct. App. 1986).

53. *Id.* at 946.

54. *Id.* at 954.

55. 821 F.2d 9 (1st Cir. 1987).

56. *Id.* at 10-11.

for the operation of plaintiff's business. In mid-May, 1979, a loan officer from the bank telephoned plaintiff and told him that the bank would not grant him any further advances.⁵⁷ Plaintiff thought at the time that this halt of further advances might be only temporary. Although the bank claimed that a letter was sent confirming the halt of credit and suggesting that plaintiff restructure his debts with another lender, plaintiff denied ever receiving the letter.⁵⁸

Thereafter, plaintiff claims that the bank mishandled and converted funds of the plaintiff. For example, plaintiff claimed that one check he had forwarded to the bank for deposit was partially credited to his account and the rest was applied to offset part of the outstanding balance of his loan. Plaintiff claimed that this action was without his authority.⁵⁹ On another occasion, plaintiff claimed that he gave the loan officer a check for several thousand dollars for deposit to his account, but that the bank converted it and used it to offset part of the outstanding balance on the loan. The bank denied the existence of the check.⁶⁰

Plaintiff testified that his first notice regarding the amount due on the loan was received September 20, 1979, although this was a past-due notice which stated that payment had been due on September 5, 1979. On November 5, 1979, the bank repossessed plaintiff's personal automobile and one of his vans. Plaintiff discovered one of the vehicles in a lot and attempted to drive it away, but was arrested and placed in jail. Thereafter, plaintiff's business collapsed and he lost his four vehicles and his home. On November 7, plaintiff filed for bankruptcy. Plaintiff's wife suffered emotional problems and drug dependency and the couple separated for a year and a half.⁶¹

At trial, even though the jury found for the bank on plaintiff's claim that the express terms of the credit agreement had been violated, the jury found for the plaintiff on the pendant state claim for breach of the implied covenant of good faith and fair dealing.⁶²

Some cases have held that banks should not be obligated to continue lending in all situations. In *Flagship National Bank v. Gray Distribution Systems*,⁶³ the court held that the "good-faith" obligation implied in contracts may not be imposed to override the express terms in a contract. Accordingly, it was held that the lender was under no obligation to con-

57. *Id.* at 11.

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.* at 12.

63. 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986).

tinue lending absent some mandatory contractual agreement.⁶⁴ This court declined to follow *K.M.C. Co. v. Irving Trust Co.*⁶⁵ and held that the bank was under no obligation to continue lending beyond the loan limit where the course of dealings involving loans in excess of the stated limit covered a period of only a few months, and the bank had given adequate notice of its refusal to extend further credit.⁶⁶

The court quoted the Florida Fourth District case of *Grandin Industries v. Florida National Bank*⁶⁷ which stated, “[w]hether or not the bank loaned money was solely a matter within the bank’s prerogative and the refusal of the bank to loan money was not a breach of contractual obligation”⁶⁸ Further addressing a lender’s obligation to complete funding a line of credit, the Fourth District in *Midlantic National Bank v. Commonwealth General, Ltd.*⁶⁹ concluded that a lender has no legal obligation to fund a line of credit.⁷⁰

In another jurisdiction, the court held for the bank in an action brought against the bank for fraud, breach of the duty of good faith, and prima facie tort in the case of *Rigby Corp. v. Boatmen’s Bank & Trust*.⁷¹ *Rigby* involved a suit arising out of a commercial loan transaction wherein the borrower alleged that the bank had wrongfully accelerated the debt and requested additional collateral. The note and security agreement provided for the acceleration of the debt and for additional security should the bank “deem itself insecure.” The note was due on October 25, 1976. The bank notified the borrower that the note would be called on that date. Plaintiff had already prepared a petition for bankruptcy, but hoped to continue the loan. At a meeting, the bank refused to continue the loan unless more collateral was pledged. Plaintiff responded that it did not have any more collateral to give, and the meeting was concluded with the bank confirming that the note was called.⁷²

The circuit court granted the bank’s motion for summary judgment, and plaintiff appealed. The court of appeals held that the bank acted in good faith in calling the note due on the date of maturity and seeking additional collateral in order to renew, that there was no cause of action under the Uniform Commercial Code for breach of the duty of good faith, and that the plaintiff’s bankruptcy was not the result of the bank’s

64. *Id.* at 1340.

65. 757 F.2d 752 (6th Cir. 1985).

66. *Flagship*, 485 So. 2d at 1341.

67. 267 So. 2d 26 (Fla. Dist. Ct. App. 1972).

68. *Id.* at 26.

69. 386 So. 2d 31 (Fla. Dist. Ct. App. 1980).

70. *Id.* at 34.

71. 713 S.W.2d 517 (Mo. Ct. App. 1986).

72. *Id.* at 520.

failure to renew.⁷³

From a review of the cases in the area of lenders' refusal to advance credit to borrowers, it is clear that while various jurisdictions differ as to what they will find as constituting bad faith, banks have been held to a higher duty in recent years to act in good faith with respect to their customers. Lenders must evaluate certain criteria before calling a loan due or refusing to continue advancing money on a line of credit. A few guidelines that lenders should consider include:

1. Keep the borrower apprised of the lender's actual intentions as to whether it will cease or continue advancing credit.
2. Give adequate written notice to a borrower prior to calling a loan due or discontinuing the advancement of funds so that the borrower has a reasonable opportunity to seek alternative financing.
3. Avoid threats of default in order to induce the borrower to follow the lender's advice.
4. Avoid personality conflicts with the borrower and act professionally.
5. Consider whether a course of dealing has been established contrary to the written terms of the loan agreement.
6. Give reasonable written notice before taking any discretionary actions against the borrower.
7. Reduce all promises to writing.
8. Maintain current records on all loan files.
9. Never give advice to a borrower that could be interpreted as exerting control over his business.

In short, lenders must act fairly with their borrowers and disclose their intentions with regard to the handling of the borrowers' loans, especially when discretionary clauses or lines of credit are involved. While the trend of recent decisions has been toward placing a higher duty on lenders in their treatment of borrowers, there appears to be a return to an emphasis on contractual rights vis-a-vis tort rights. Therefore, lenders' positions may improve in the future, which will enable them to enforce more aggressively their contractual rights and secure their position as a creditor. In the meantime, lenders must proceed cautiously whenever they establish a lender/borrower relationship.

73. *Id.* at 517.