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A Survey, Comparison and Comment**

by

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LENDER LIABILITY IN MISSISSIPPI: A SURVEY, COMPARISON AND COMMENT

Robert C. Williamson, Jr. and Brenda Kay Tanner***

“FROM THE Oil Patch to the Farm Belt,”¹ lenders are contending with lawsuits brought by financially beleaguered borrowers and their unsecured creditors.² The borrower cases ordinarily involve two actors — the lender and a distressed business. The borrower blames the lender for its business set-backs, contending that the lender prematurely called its loan,³ interfered in business decision-making⁴ or withheld material information.⁵

The creditor cases involve three actors — the lender, an insolvent business, and an unsecured or undersecured creditor of the business. The creditor blames the lender for the losses it in-

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¹ Victor, *Lender Liability Doctrine Gives Creditors Clout*, National Law Journal, Sept. 1, 1986, at 1, col. 2.

² See, e.g., Gray v. First Nat'l Bank of Louisville, No. J88-0324(B)(S.D. Miss. filed June 28, 1988)(seeking 11 million dollars in actual and punitive damages on multiple theories of lender liability); University of Tenn. v. United States Fidelity & Guar. Co., No. 2-130-87 (Circuit Court of Knox County, Tenn. filed March 6, 1987)(bond obligee seeking over 107 million dollars in actual, punitive damages against financing contract surety for alleged domination, control of bond principal on construction projects); Hunt v. Bankers Trust Co., No. 3-86-1984 (N.D. Tex. filed June 24, 1986)(seeking \$3.6 billion on multiple theories of lender liability). The authors represent the defendant in the *University of Tenn.* action and are acting as special Mississippi counsel to the lenders in the *Hunt* action. Nothing stated in this Article is intended as a comment on any pending litigation in which the authors represent any of the parties.

³ See *infra* notes 39-48 and accompanying text.

⁴ See *infra* notes 239-268 and accompanying text.

⁵ See *infra* notes 116-151 and accompanying text.

curred in extending credit to the business, arguing that the lender used its financial leverage over the business to injure the creditor⁶ or that the lender provided the creditor with inaccurate information about the business' creditworthiness.⁷

Lender liability cases are not new. Reported decisions date back to the nineteenth century.⁸ The recent explosion in litigation is partially attributable to changes in the economy, the financial industry, and judicial views regarding compensation for injury.⁹ A more immediate inspiration for litigation has been the breathtaking verdicts¹⁰ won by disgruntled borrowers and creditors.

Successful claimants have relied on a "dazzling array of

⁶ See *infra* notes 297-348 and accompanying text.

⁷ See *infra* notes 408-429 and accompanying text.

⁸ See, e.g., *American Nat'l Bank v. National Wall-Paper Co.*, 77 F. 85, 90-94 (8th Cir. 1896)(liability imposed upon lender for scheming to injure borrower's creditors). See generally, Rudolph, *The Domination Issue in Contract Suretyship Cases*, 1949 INS. L.J. 740 (1949)(surveying ten early cases).

⁹ For an in-depth and scholarly analysis of these changes, see Ebke & Griffin, *Lender Liability to Debtors: Toward A Conceptual Framework*, 40 Sw. L.J. 775, 800-806 (1986).

¹⁰ See, e.g., *Landes Constr. Co. v. Royal Bank*, 833 F.2d 1365, 1367-68 (9th Cir. 1987)(\$18.5 million for breach of oral loan commitment); *Whitney v. CitiBank, N.A.*, 782 F.2d 1106, 1113-1120 (2d Cir. 1986)(affirming verdict for \$236,677 in compensatory damages, \$1.5 million in punitive damages for interference with partnership); *999 v. C.I.T. Corp.*, 776 F.2d 866, 867-68 (9th Cir. 1985)(\$925,000 verdict for breach of loan commitment); *K.M.C. Co., v. Irving Trust Co.*, 757 F.2d 752, 754 (6th Cir. 1985)(jury verdict for \$7.5 million for breach of UCC implied covenant of good faith in failing to give notice before refusing loan advances); *Penthouse Int'l v. Dominion Fed. Sav. & Loan Ass'n*, 665 F. Supp. 301, 312 (S.D. N.Y. 1987)(\$129,904,455 in compensatory damages for breach of loan commitment); *Ricci v. Key Bancshares of Maine, Inc.*, 662 F. Supp. 1132, 1139-43 (D. Me. 1987)(\$15 million in actual damages for breach of implied covenant of good faith in abruptly terminating line-of-credit); *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661, 667 (Tex. Ct. App. 1984)(\$18,647,243.77 in compensatory damages).

Some of the most spectacular verdicts have not yielded published opinions. See, e.g., *Conlan v. Wells Fargo Bank, N.A.*, No. 82852 (Cal. App. Dept. Super. Ct., June 10, 1987)(jury award of \$10 million in compensatory damages, \$50 million in punitive damages for fraud, duress, breach of covenant of good faith, fair dealing, breach of contract), noted in 1 *Lender Liability L. Rep.* 3 (Sept. 1987); *Scharenberg v. Continental Ill. Nat'l Bank*, No. 84-2712-Civ-Davis; No. 87-0211-Civ-Davis; No. 87-0238-Civ-Davis (S.D. Fla. 1987)(\$105 million in compensatory damages for breach of loan agreement), noted in 1 *Lender Liability L. Rep.* 4 (Aug. 1987); *Solomon & Sands v. First Am. Nat'l Bank*, No. 84-1445-I (Tenn. Ch. App. Davidson County, Sept. 23, 1987)(\$200,000 in compensatory, \$1.2 million in punitive damages for fraud, breach of obligation of good faith, reckless disposition of collateral), noted in 1 *Lender Liability L. Rep.* 1 (Nov. 1987).

lender liability theories."¹¹ These theories include traditional

¹¹ Murphy, *Introduction to the Defense and Prevention of Lender Liability*, I ALI-ABA COURSE OF STUDY, LENDER LIABILITY DEFENSE AND PREVENTION 3-4 (1987) [As several articles from this particular publication, volumes I and II, will be referred to herein, the publication will be hereinafter cited as ALI-ABA]. In addition to the common law theories of recovery, certain statutory provisions have been used to support actions against lenders. The Uniform Commercial Code (U.C.C.) provisions of good faith and fair dealing are most often cited. See *infra* notes 27-78 and accompanying text. The U.C.C. provisions of Article Nine are especially pertinent to Mississippi lenders, since a significant portion of financing in Mississippi is agricultural. With the increasing number of defaults and bankruptcies by farmers, lenders' ability to foreclose upon agricultural collateral, including crops, livestock, and equipment, becomes more crucial. For a thorough discussion of Article Nine and its effect on Mississippi lenders, see Meyer, *Agricultural Collateral and Article Nine - Mississippi Style*, 42 MISS. L. INST. 29 (1987). See also Burke, *General Observations Concerning Article 9 Sales*, I ALI-ABA 71, at 71-119 (1987)(general discussion of Article 9) [hereinafter cited as Burke, *General Observations*]. For a general discussion of lender liability for agricultural loans, see Bahls, *Termination of Credit for the Farm or Ranch: Theories of Lender Liability*, 48 MONT. L. REV. 213 (1987).

The securities laws may also be used as a basis for asserting liability against a lender. Such liability may arise under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, and/or the Mississippi Securities Act, MISS. CODE ANN. § 75-71-101 *et seq.* (Supp. 1987). Under these securities laws, several theories of liability may be asserted against a lender, including liability as a control person, aider and abettor, co-conspirator, principal, information supplier, and/or seller. See generally Burke, *Emerging Theories of Lender Liability*, I ALI-ABA 397, 442-462 (1987)(discussion of lender's liability under securities laws) [hereinafter cited as Burke, *Emerging Theories*]; Douglas-Hamilton, *When Are Creditors in Control of Debtor Companies?*, 26-7 PRACT. LAW. 61 (1980)(discussion of control); Enstam & Kamen, *Control And The Institutional Investor*, 23 BUS. LAW. 289 (1968)(same); Heiman, *Impact of Common Law Theories On Lender Recovery and Liability*, IV ABA EMERGING THEORIES OF LENDER LIABILITY 7, 16-17 (H. Chaitman ed. 1987)(same) [As several articles from this particular publication will be referred to herein, the publication will be hereinafter cited as IV ABA Emerging Theories]; Lundgren, *Liability Of A Creditor In A Control Relationship With Its Debtor*, 67 MARQ. L. REV. 523, 546-549 (1984)(discussion of securities laws).

Under the Bankruptcy Code, a lender with sufficient control might be classed as an "insider", with the result that certain transactions may be classed as preferential transfers. For a discussion of the effect of the bankruptcy laws on lenders, see Burke, *Emerging Theories*, *supra*, at 463-64; Lundgren, *supra*, at 523, 552-555; Miller, Bienenstock, Ball & Gatto, *Confirmation of Chapter 11 Plans under the Bankruptcy Code*, II ALI-ABA 863, 863-1040; Murphy, Sheneman & Nelson, *Lender Liability: Remedies and Defenses in Bankruptcy Cases*, II ALI-ABA 759, 759-862. Like preferential transfers under the Bankruptcy Code, the Uniform Fraudulent Conveyance Act (UFCA) can be used to void transfers. See Heiman, *supra*, at 31-41. Mississippi has not adopted the UFCA. However, Mississippi has several statutory provisions addressing fraudulent transfers which could be used, like the UFCA, to void transfers. See MISS. CODE ANN. §§ 11-5-75, 15-3-5 (1972), 15-3-3 (Supp. 1987)(statutory provisions which provide for avoidance of fraudulent transfers). For a discussion of fraudulent conveyance risks for lenders in

breach of contract and tort theories, such as breach of an ex-

leveraged buyouts, see Kirby, McGuinness and Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27 (1987); Murdoch, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles*, 43 BUS. LAW. 1 (1987).

The Racketeer Influenced and Corrupt Organizations Act (RICO) also can be a source of liability for lenders. See Burke, *Emerging Theories, supra*, at 521-594 (discussion of RICO); Greenberg, *An Update On Civil RICO After Sedima And The Implications For Lenders*, IV ABA EMERGING THEORIES 83, 83-100 (same).

Under the Internal Revenue Code, a lender may be liable for unpaid withholding taxes of the borrower. The degree of liability varies according to the extent of participation by the lender. For example, a lender who directly pays the borrower's employees must withhold the appropriate taxes and pay such taxes to the government. Any lender classed as a "responsible person" may likewise be liable for the full amount of taxes. On the other hand, a lender who advances money for payment of wages is liable only up to 25 percent of the amount of advanced funds, even though the lender knows the borrower does not intend to pay the taxes. See Burke, *Emerging Theories, supra*, at 462-63 (discussion of liability for withholding taxes); Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595 (1982)(same); Douglas-Hamilton, *supra*, at 70-72 (same); Feldman, *Taxation-Exercise Of Only "Significant" Control Over Debtor's Operations Subjects Lender to 100 Percent Withholding Tax Penalty*, 43 FORDHAM L. REV. 898 (1975)(same); Lundgren, *supra*, at 540-546 (same); Thannhauser, Riemer, & Friedman, *Lender's Liability for Unpaid Withholding Taxes of Borrower-Employer—IRC Sections 3505 and 6672*, 80 COM. L.J. 137 (1975)(same); Winston, *Lender's Liability For Borrower's Unpaid Employment Taxes*, TEX. B. J. 1253 (Nov. 1983)(same). Liability for taxes under these provisions extends to any "lender, surety, or other person." Thus, a prime contractor who loaned money to its subcontractor to pay its net payroll was held liable for withholding taxes in *United States v. Algernon Blair, Inc.*, 441 F.2d 1379, 1381 (5th Cir. 1971).

An area of increasing concern to lenders involves the environmental protection laws. Laws to penalize improper disposal of hazardous waste may cause government claims for clean-up costs to have priority over other liens; arguably costs of clean up may become a direct liability of secured lenders. Cohen, *Hazardous Waste: A Threat to the Lender's Environment*, 19 U.C.C. L.J. 99, 99 (1986)(thorough analysis of lender's liability for hazardous wastes under federal and state laws); see also Article, *When a Security Becomes a Liability: Claims Against Lenders in Hazardous Waste Cleanup*, 38 HASTINGS L.J. 1261 (1987)(same).

The aforementioned statutory provisions are only a few of many statutes under which lenders may find themselves liable for acts or failure to act of borrowers. Any time a lender exercises control over a borrower the potential arises for liability. For a discussion of potential liability under other statutory provisions such as the Investment Company Act of 1940, the Trust Indenture Act of 1939, the Public Utility Holding Company Act of 1935, the Interstate Commerce Act, the Civil Aeronautics Act, the Federal Communications Act of 1934, Antitrust laws, etc., see Enstam & Kamen, *supra*, at 292-297. One author warns that lender liability cases based on statutory provisions should be read with caution since "control liability statutes may have been enacted precisely because common law theories of liability were perceived as inadequate to remedy the targeted ills." Schechter, *The Principal Principle: Controlling Creditors Should Be Held Liable For Their Debtors' Obligations*, 19 U.C. DAVIS L. REV. 875, 906 n.66 (1986).

press promise,¹² fraud¹³ and duress.¹⁴ Of particular importance are cases imposing liability upon lenders for breach of fiduciary obligations,¹⁵ breach of an implied duty of good faith,¹⁶ and interference with borrower management.¹⁷

Theories such as fraud or breach of an express covenant are as viable in Mississippi as in other states.¹⁸ Mississippi courts have not imposed a general fiduciary obligation upon commercial lenders;¹⁹ nor have they used the implied covenant of good faith to prohibit lenders from exercising rights granted them by their loan agreements.²⁰ Mississippi courts have, however, recognized that lenders may have special disclosure obligations, which extend not only to the lender's own customers,²¹ but also to third parties such as creditors who reasonably rely upon information provided by the lender.²²

This article surveys the legal theories relied upon by borrowers and creditors in recent lender liability cases. The article is divided into two parts: Part I focuses on theories utilized by borrowers; Part II focuses on theories asserted by unsecured creditors. Each section analyzes the leading lender liability cases, including pertinent Mississippi decisions, and comments on the applicability of the particular lender liability theory under Mississippi law. The authors conclude that Mississippi courts should not rush to embrace the so-called "emerging theories of lender liability." Lenders ordinarily should be permitted to enforce their loan agreement as written; legal theories that impose ambiguous limitations on lenders' ability to rely on the express terms of their loan agreements should be rejected.

¹² See *infra* note 36.

¹³ See *infra* notes 196-214, 385-407 and accompanying text.

¹⁴ See *infra* notes 215-238 and accompanying text.

¹⁵ See *infra* notes 91-176, 349-384 and accompanying text.

¹⁶ See *infra* notes 23-90 and accompanying text.

¹⁷ See *infra* notes 239-274, 430-441 and accompanying text.

¹⁸ See *infra* notes 211-214 and accompanying text.

¹⁹ See *infra* notes 152-176 and accompanying text.

²⁰ See *infra* notes 84-88 and accompanying text.

²¹ See *infra* notes 160-166 and accompanying text.

²² See *infra* notes 408-429 and accompanying text.

I. BORROWER THEORIES

A. Breach of the Implied Covenant of Good Faith

Most American jurisdictions agree that every contract contains an implied covenant of good faith.²³ A common law obligation of "good faith and fair dealing" is recognized by the Restatement (Second) of Contracts.²⁴ Recognition of the covenant of good faith is mandatory in transactions governed by the Uniform Commercial Code (U.C.C.).²⁵ In some jurisdictions, breach of this covenant may result in the imposition of tort as well as contractual liability.²⁶

²³ See Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 404 app. (1980)(collection of cases from various jurisdictions).

²⁴ RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

²⁵ See U.C.C. § 1-203; MISS. CODE ANN. § 75-1-203 (1972)("Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement."); see, e.g., *Commercial Cotton Co. v. United California Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554 (1985)(liability imposed on bank for breach of duties of good faith for refusing to recredit customer's account after payment of check with unauthorized signatures). See generally Burke, *Emerging Theories*, supra note 11, at 473-520 (discussion of UCC provisions of good faith and fair dealing); Kitada, *Emerging Theories of Bank Liability - The Breach of the Covenant of Good Faith and Fair Dealing*, 103 BANKING L.J. 80 (1986)(same).

²⁶ A number of jurisdictions permit recovery in tort for bad faith breach of an insurance contract. See S. ASHLEY, *BAD FAITH ACTIONS: LIABILITY AND DAMAGES* § 2:05 at 9, 10 n.1 (1984)(cataloging cases). Most courts have refused to extend this tort to other commercial contracts. *Id.* § 11.03 n. 1 (listing cases); see, e.g., *Betterton v. First Interstate Bank*, 800 F.2d 732, 736 (8th Cir. 1986)(lender liability case); *Carrico v. Delp*, 141 Ill. App. 3d 684, 490 N.E. 972, 977 (1986)(same). However, some jurisdictions, most notably California and Montana, have extended the bad faith tort doctrine to employment contracts, e.g., *Smithers v. Metro-Goldwyn-Mayer Studios, Inc.*, 139 Cal. App. 3d 643, 189 Cal. Rptr. 20, 23-24 (1983); *Gates v. Life of Montana Ins. Co.*, 205 Mont. 304, 668 P.2d 213, 214 (1983); bank deposit contracts, e.g., *Commercial Cotton Co. v. United Cal. Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554-55 (1985); *First Nat'l Bank v. Twombly*, 689 P.2d 1226, 1230 (Mont. 1984); loan agreements, e.g., *Barrett v. Bank of Am.*, 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16, 20-21 (1986); *Noonan v. First Bank*, 740 P.2d 631, 635 (Mont. 1987); and certain other kinds of offensive business conduct, e.g., *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354, 362-63 (1984)(denying existence of contract); *Nicolson v. United Pacific Ins. Co.*, 710 P.2d 1342, 1347 (Mont. 1985)(malicious conduct). The Montana Supreme Court's approach is detailed in Comment, *Commercial Bad Faith: Tort Recovery for Breach of Implied Covenant in Ordinary Commercial Contracts*, 48 MONT. L. REV. 349 (1987). For a persuasive criticism of this tort, see Comment, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing Into the Commercial Realm*, 86 COLUM. L. REV. 377 (1986). For a con-

The duty of good faith creates troubling issues for lenders. Initially, "good faith" conduct must be distinguished from "bad faith" conduct. Courts disagree whether good faith requires pure motives, commercial reasonableness or both. Many of the cases focus on section 1-208 of the U.C.C., which provides that a contract clause permitting acceleration of a loan "at will" or when a lender deems itself "insecure", is enforceable only if the lender "in good faith believes that the prospect of payment or performance is impaired."²⁷ One line of cases holds that the test for good faith under this section is whether the lender "honestly believes" its prospects of payment are impaired.²⁸ This view, some-

trary view, 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. 896, 905-10 (1986)(advocating recognition of tort liability by Iowa courts); Comment, *Lenders' Liability - The Shift From Contract to Tort Doctrine Deters Banks From Enforcing Unjustified and Detrimental Contract Provisions*, 21 J. MARSHALL L. REV. 372, 383-85 (1988)(advocating imposition of tort liability against banks).

Tort liability was imposed on a lender for negligently processing a loan application in *Jacques v. First Nat'l Bank*, 307 Md. 527, 515 A.2d 756 (1986). The duty breached was an implied covenant of reasonable care imposed on the lender by public policy. *Id.* at 759-60. For a critical review of *Jacques*, see Ellis & Gray, *Lender Liability For Negligently Processing Loan Applications*, 92 DICK. L. REV. 363 (1988).

Mississippi permits the recovery of tort damages when a breach of contract is attended by such intentional wrongdoing or gross negligence as to amount to an independent intentional tort for which punitive damages may be recoverable. See *Fedders Corp. v. Boatright*, 493 So. 2d 301, 311 (Miss. 1986)(recognizing punitive damages may be recovered for tortious breach of contracts governed by U.C.C.). Most of the reported cases involve claims against insurance companies. Until recently the Mississippi Supreme Court indicated the standard for imposing tort liability on an insurance contract was no different from the standard applicable to other types of contracts. See, e.g., *Reserve Life Ins. Co. v. McGee*, 444 So. 2d 803, 807 (Miss. 1984)(criticizing use of the term "bad faith"). However, in *Blue Cross & Blue Shield of Miss., Inc. v. Maas*, 516 So. 2d 495 (Miss. 1987), a majority of the court joined in a special concurrence by Judge Robertson recognizing "the tort of bad faith refusal to pay timely a legitimate [insurance] claim" for which "ordinary tort damages" for economic loss (including attorney's fees) and emotional distress damages could be awarded. *Id.* at 498. The concurrence implied these damages would have been recoverable, even if the circumstances did not justify the imposition of punitive damages. For Judge Robertson's views on this subject, see his concurrence in *Pioneer Life Ins. Co. v. Moss*, 513 So. 2d 927, 931 (Miss. 1987) and his dissent in *Blue Cross & Blue Shield of Miss., Inc. v. Campbell*, 466 So. 2d 833, 850 (Miss. 1984). It is unclear whether the Mississippi Supreme Court will extend this bad faith tort concept outside the insurance context.

²⁷ U.C.C. § 1-208; MISS. CODE ANN. § 75-1-208 (1972).

²⁸ See, e.g., *Ginn v. Citizens and Southern Nat'l Bank*, 145 Ga. App. 175, 243 S.E.

times referred to as "the pure heart and empty head" standard,²⁹ is consistent with section 1-201 of the U.C.C., which defines "good faith" as "honesty in fact."³⁰ Another line of cases holds that a lender's belief that its prospect of payment is impaired must be commercially reasonable, as well as honest.³¹ This view, which amounts to a negligence standard, is supported by a comment to the Restatement (Second) of Contracts, which states that good faith and fair dealing require adherence to "community standards of decency, fairness or reasonableness."³²

An even more troubling issue is the relation, or lack thereof, between the implied duty of good faith and the express rights and obligations contained in the parties' loan agreement. Here

2d 528, 530 (1978)(issue is whether lender acted honestly); *Van Horn v. Van De Wol, Inc.*, 6 Wash. App. 959, 497 P.2d 252, 253 (1972)("negligence irrelevant to good faith" under U.C.C.). One court approved the following jury instruction regarding the U.C.C. duty of good faith: "Good faith means that one acts without any improper motivation. One acts with the truth and not for some ulterior motive that is unconnected with the substance of the agreement in question when one is acting in good faith." *Reid v. Key Bank of Southern Maine, Inc.*, 821 F.2d 9, 15 (1st Cir. 1987)(upholding jury verdict for actual, punitive damages for breach of duty of good faith in U.C.C. §§ 1-203, 208). A fundamental problem with this definition is the implication that "any improper motivation" is sufficient to impose liability. The mere existence of an improper purpose should not be considered bad faith so long as an actor's primary motivation is legitimate. See *RESTATEMENT (SECOND) OF TORTS § 769(d)*(1979)(conditional privilege to interfere with prospective business relation if purpose is at least in part to advance actor's competitive interest).

²⁹ *Black v. Peoples Bank and Trust Co.*, 437 So. 2d 26, 29 (Miss. 1983).

³⁰ U.C.C. § 1-201 (19); *MISS. CODE ANN. § 75-1-201* (19)(1972).

³¹ See, e.g., *Sheppard Fed. Credit Union v. Palmer*, 408 F.2d 1369, 1370-71 (5th Cir. 1969)(applying objective test).

³² *RESTATEMENT (SECOND) OF CONTRACTS § 205 comment a* (1979). The Reporters' comment to the Restatement states that the obligation of good faith and fair dealing "may require more than honesty." *RESTATEMENT (SECOND) OF CONTRACTS § 205 comment d* (1979). The comment catalogs the following examples of bad faith: "Evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance." *Id.* at comment d. For other views on the problem of distinguishing good faith from bad faith, see *Burton, supra* note 23 at 505 (bad faith is using discretionary contract authority to recapture opportunities lost as result of entering contract); *Stankiewicz, Good Faith Obligation in the Uniform Commercial Code: Problems in Determining and Evaluating its Effect*, 7 *VAL. U. L. REV.* 389, 400 (1973)(define by bootstrapping on earlier courts' finding of bad faith); *Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 *VA. L. REV.*, 195, 199-200 (1968)(cannot be defined other than as excluder of bad faith).

the question is whether a lender's subjective or objective "good faith" matters at all if the loan agreement authorizes the lender's action.³³ Initially, courts used the covenant of good faith to determine the intent of the parties when the contract was silent about a particular matter.³⁴ Over time, however, some courts began to use the covenant to limit the exercise of contract rights that offended the court's view of fairness.³⁵

Lenders have been held liable for breach of the duty of good faith for failing to honor loan commitments,³⁶ refusing to make loan advances³⁷ and for improper acceleration of due dates.³⁸ In

³³ T. Quinn, *Uniform Commercial Code Commentary and Law Digest* § 1-208[A][1] (Supp. 1986).

³⁴ See, e.g., *Riess v. Murchison*, 503 F.2d 999, 1001, 1012 (9th Cir. 1974), (finding implied covenant to endeavor in good faith to produce, save, sell water), cert. denied, 420 U.S. 993 (1975); *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214, 214 (1917)(implied duty to use reasonable efforts in performance of contract).

³⁵ See, e.g., *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985)(refusal to make discretionary loan advances); *Neumillar Farms v. Cornett*, 368 So. 2d 272, 275 (Ala. 1979)(buyer may reject goods based on claim of dissatisfaction only in good faith).

³⁶ See, e.g., *999 v. C.I.T. Corp.*, 776 F.2d 866, 872 (9th Cir. 1985)(breach of binding written commitment). The implication of a duty of good faith can sometimes assist lenders in enforcing commitments. See, e.g., *Teachers Ins. & Annuity Ass'n v. Butler*, 626 F. Supp. 1229, 1235-36 (S.D. N.Y. 1986)(putative borrowers' breach of written loan commitment). These decisions are troubling in that the same result probably could have been reached without reliance on an ambiguous implied duty of good faith. For instance, in *Shaughnessy v. Mark Twain State Bank*, 715 S.W. 2d 944 (Mo. Ct. App. 1986), the court found that, absent default, a line of credit was a commitment to lend the full amount of the authorized credit because a commitment fee had been paid and the parties had agreed on a definite expiration date. *Id.* at 953-55. In so holding, however, the court refused to find breach of an implied covenant of good faith. *Id.* at 953; see also *Landes Const. Co., Inc. v. Royal Bank*, 833 F.2d 1365, 1368-69 (9th Cir. 1987)(oral commitment partially performed); *National Farmers Org., Inc. v. Kinsley Bank*, 731 F.2d 1464 (10th Cir. 1984)(breach of commitment); *Sterling Faucet Co. v. First Mun. Leasing Corp.*, 716 F.2d 543, 544 (8th Cir. 1983)(same); *Penthouse Int'l v. Dominion Sav. & Loan Ass'n*, 665 F. Supp. 301, 309-11 (S.D. N.Y. 1987)(breach of written commitment); *Consolidated American Life Ins. Co. v. Covington*, 297 So. 2d 894, 898 (Miss. 1984)(holding issue of whether borrower had complied with conditions of commitment was jury question).

³⁷ See, e.g., *Reid v. Key Bank, Inc.*, 821 F.2d 9, 12-15 (1st Cir. 1987)(termination of line of credit agreement); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985)(good faith limitation on right to refuse advances without notice); *Ricci v. Key Bancshares of Maine, Inc.*, 662 F. Supp. 1132, 1141 (D. Me. 1987)(termination of line of credit agreement); *Carrico v. Delp*, 141 Ill. App. 3d 684, 490 N.E. 2d 972, 976 (1986)(same).

³⁸ See, e.g., *Betterton v. First Interstate Bank*, 800 F.2d 732, 733-35 (8th Cir. 1986)(acceleration of note despite oral agreement to extend); *Brown v. Avemco Investment Corp.*, 603 F.2d 1367, 1375-79 (9th Cir. 1979)(acceleration for technical default

some of these cases, the courts extended section 1-208 of the U.C.C., which expressly applies only to acceleration when a lender deems itself insecure, to lenders' refusal of discretionary loan advances and to demand notes.

The best known of these cases is *K.M.C. Co. v. Irving Trust Co.*,³⁹ a federal appellate decision upholding a 7.5 million dollar jury verdict against a lender for destruction of its borrower's business.⁴⁰ The parties' financing agreement provided that Irving Trust could loan, in its discretion, "up to" an agreed credit line and "up to" a certain maximum percentage of K.M.C.'s accounts receivable and inventory.⁴¹ Repayment was due on demand.⁴² To secure repayment, K.M.C. agreed to deposit the proceeds from its receivables into a "blocked account" over which Irving Trust had exclusive control. This arrangement left K.M.C. wholly dependent upon Irving Trust for operating funds.⁴³ Over a three year period, the parties developed a course of dealing in which Irving Trust would advance funds under the line-of-credit to cover K.M.C.'s outstanding checks.⁴⁴

where lender was fully secured); *Layne v. Fort Carson Nat'l Bank*, 655 P.2d 856, 857-58 (Colo. Ct. App. 1982)(enforcement of due-on-sale clause where lender secured); *Universal C.I.T. Credit Corp. v. Sheperd*, 164 Ind. App. 516, 329 N.E. 2d 620, 623-24 (1975)(applying objective test in action for conversion of seized collateral); *First Nat'l Bank v. Twombly*, 689 P.2d 1226, 1229-30 (Mont. 1984)(seizure of collateral after oral agreement to extend loan); cf. *Sahadi v. Continental Ill. Nat'l Bank & Trust Co.*, 706 F.2d 193, 196-97 (7th Cir. 1983)(acceleration for nonmaterial breach when note payment only one day late).

³⁹ 757 F.2d 752 (6th Cir. 1985).

⁴⁰ *Id.* at 766.

⁴¹ *Id.* at 754.

⁴² *Id.* at 760. Neither the demand provision nor the parties' agreement was quoted in the court's opinion. At least one commentator has suggested the loan documents did not contain an unconditional right of demand. See Warren, *Good Faith and Fair Dealing Under the Uniform Commercial Code*, I ABA EMERGING THEORIES OF LENDER LIABILITY 57, 67-68 (H. Chaitman ed. 1985)(financing agreement inconsistently provided for 60 days notice of termination of agreement). [As several articles from this particular publication, volumes I, II, and III, will be referred to herein, the publication will be hereinafter cited as ABA.]

⁴³ *K.M.C. Co.*, 757 F.2d at 759. The court recognized that the power afforded Irving Trust by the terms of the financing agreement and the blocked account arrangement left "K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance." *Id.*

⁴⁴ The trial court's memorandum denying Irving's motion for J.N.O.V. notes that "the parties had established a pattern of doing business under the Financing Agreement

K.M.C. began to experience financial problems and requested a \$500,000 increase in its credit line. One week later, K.M.C. asked Irving Trust to advance the balance of its credit limit to cover overdrafts. Although fully secured, Irving Trust refused to make the requested advance.⁴⁵ K.M.C.'s checks were dishonored, and despite later advances by Irving Trust, K.M.C.'s business was destroyed.⁴⁶

Evaluating the *K.M.C. Co.* decision is difficult because the opinion contains contradictory findings. The court held that Irving Trust had a good faith obligation to give K.M.C. notice and an opportunity to secure alternative financing before exercising its discretion not to make further advances, absent a "valid business reason precluding Irving Trust from doing so."⁴⁷ Paradoxically, the court also held that the duty of good faith limited Irving Trust's discretionary authority to refuse further loans and to demand payment of funds already advanced.⁴⁸

The court gleaned its notice rule from a nineteenth century New York decision⁴⁹ and from the commentary to section 2-309 of the U.C.C., which applies to the termination of sales contracts with indefinite durations.⁵⁰

whereby Irving Trust would transfer funds to cover outstanding checks in K.M.C.'s account at Park National Bank in accordance with formulas established by quarterly audits of K.M.C. by Irving Trust, and when requests for such transfers were made by K.M.C." *K.M.C. Co. v. Irving Trust Co.*, No. Civ-3-82-365 (E.D. Tenn. 1983), reprinted in I ABA 83, 83-100.

⁴⁵ *K.M.C. Co.*, 757 F.2d at 762.

⁴⁶ *Id.* at 754, 762.

⁴⁷ *Id.*

⁴⁸ *Id.* "There is ample evidence in the record to support a jury finding that no reasonable loan officer in the same situation would have refused to advance funds to K.M.C. without notice." *Id.*; see *In re Red Cedar Constr. Co.*, 63 Bankr. 228, 237 (Bankr. W.D. Mich. 1986)(construing *K.M.C. Co.*). A personality conflict between K.M.C.'s president and a loan officer may have partially motivated Irving Trust's actions. *K.M.C. Co.*, 757 F.2d at 761.

⁴⁹ See *Wells v. Alexandre*, 130 N.Y. 642, 29 N.E. 142, 143 (1891)(imputing notice provision as gap filler in requirements contract), cited in *K.M.C. Co.*, 757 F.2d at 759. The *K.M.C. Co.* court cited *Wells* for the proposition that any construction of the contract that would place one of the parties entirely at the mercy of the other party is unreasonable and that a covenant to give notice will be implied in such situations. See *infra* notes 379-384 and accompanying text.

⁵⁰ *K.M.C. Co.*, 757 F.2d at 759. U.C.C. § 2-309 provides that termination of a contract other than by an agreed event requires reasonable notice and that an agreement waiving notice is invalid if its operation would be unconscionable. Comment 8 to this

The court relied upon section 1-208 of the U.C.C. in placing a good faith limitation on Irving Trust's discretion to make further advances and to demand payment of loans.⁵¹ To support this reliance, the court cited *Brown v. Avemco Investment Corp.*,⁵² a frequently criticized decision of the Ninth Circuit, which held that section 1-208 precludes acceleration for default — as well as for insecurity — unless the lender concludes, in good faith, that its prospects for payment are impaired.⁵³

In *K.M.C. Co.*, Irving Trust argued that the test for good faith under section 1-208 was whether its loan officer honestly believed he had a valid reason for not making further advances to K.M.C. The court disagreed, reasoning that good faith requires "some objective basis" from which a "reasonable loan officer" would conclude that funds should be refused.⁵⁴ Since Irving Trust was fully secured, the court concluded that K.M.C.'s financial difficulties were insufficient justification for refusing further advances.⁵⁵

section, which was quoted by the *K.M.C. Co.* court, states: "[T]he application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship and will give the other party reasonable time to seek a substitute arrangement." U.C.C. § 2-309 comment 8.

MISS. CODE ANN. § 75-2-309 is consistent with the common law rule that contracts of an indefinite duration can be cancelled only upon reasonable notice. See *First Miss. Bank of Commerce v. Latch*, 433 So. 2d 946, 950 (Miss. 1983) (reasonable notice must be given before terminating contract with indefinite duration). We suggest, however, that this rule has no application when the parties' agreement unconditionally permits termination by making demand, since by definition a demand note is payable at anytime after it is executed.

⁵¹ *K.M.C. Co.*, 757 F.2d at 759.

⁵² 603 F.2d 1267 (9th Cir. 1979), cited in *K.M.C. Co.*, 757 F.2d at 760.

⁵³ *Brown*, 603 F.2d at 1379. The action arose when a lender enforced a due-on-lease clause which permitted acceleration for default if the borrower leased an airplane securing a loan without the consent of the lender. The lender knew about the lease but nevertheless accepted payments from the lessees for 23 months before the lender accelerated. *Id.* at 1375. The court held that U.C.C. § 2-208 applied because the default provision made acceleration enforceable at the lender's option. *Id.* at 1379. The court also held that Texas imposes a common law limitation of reasonableness on the acceleration and cited with approval cases in other jurisdictions refusing to enforce due-on-sale clauses in mortgages on equitable grounds. *Id.* at 1379-80.

⁵⁴ *K.M.C. Co.*, 757 F.2d at 761.

⁵⁵ *Id.* Other factors relied upon by the court included:

(1) an admission by one of Irving's officers that he would not have been acting in good faith to refuse to advance funds to K.M.C. without notice if he believed Irving was adequately secured;

In sum, the *K.M.C. Co.* court used the covenant of good faith to graft a notice requirement into a demand loan and to limit the discretionary power given the lender under the loan agreement in making advances and requiring repayment of advances.

Admittedly, the lender's conduct reported in *K.M.C. Co.* was egregious. However, the court could have reached the same result by applying less radical contract principles. Most courts recognize that a lender may waive its contractual rights or be estopped from enforcing them by engaging in a course of conduct inconsistent with the contractual rights sought to be enforced. A finding of waiver or estoppel would have been supported by the facts reported in *K.M.C. Co.*⁶⁶ and would have

(2) testimony by a local banker that any reasonable banker evaluating the loan would have agreed it was fully secured;

(3) testimony by an attorney for another food wholesaler interested in purchasing *K.M.C.* that in a telephone conversation the loan officer acknowledged that Irving was adequately secured, that he knew terminating financing would destroy *K.M.C.*, and that he would advance the funds requested by *K.M.C.* to give the attorney an opportunity to evaluate possible acquisition of *K.M.C.* (later, the loan officer changed his mind);

(4) Irving's advancement of funds in an amount in excess of \$700,000 after March 1 to try to prop up *K.M.C.* until it could be sold.
Id. at 761-62.

⁶⁶ The trial court partially relied upon the doctrine of waiver in rejecting *K.M.C.*'s motion for judgment N.O.V. Specifically, the court held that the law will not permit one party to a contract to strictly enforce covenants in a contract when the parties' past dealings have created the impression the covenants will not be enforced, unless notice of a change in intentions is given. *K.M.C. Co.*, No. Civ-3-82-365 (E.D. Tenn. 1983) reprinted in I ABA 83, 83-101. Relying on U.C.C. § 2-208, courts have almost uniformly held that a lender may not habitually accept late payments, then attempt to declare default because a payment is late without first giving the debtor notice of an intent to strictly enforce the contract. *See, e.g.*, Nevada Nat'l Bank v. Huff, 94 Nev. 506, 582 P.2d 364, 369-70 (1978)(acceptance of late payments); Knittel v. Security State Bank, 593 P.2d 92, 95-96 (Okla. 1979)(same); Lee v. Wood Prod. Credit Union, 551 P.2d 446, 448 (Or. 1976)(same). Courts disagree on the enforceability of contract clauses which provide that the lender's waiver of one or more defaults does not constitute a waiver of later defaults. Some courts have held that anti-waiver clauses preclude modification or waiver through course of performance or dealing. *See, e.g.*, Hale v. Ford Motor Credit Co., 374 So. 2d 849, 853 (Ala. 1979)(under nonwaiver acceleration, nonmodification clauses, no notice required of secured party to take possession of collateral); Van Bibber v. Morris, 275 Ind. 555, 419 N.E. 2d 115, 121 (1981)(same). Other courts have held that antiwaiver clauses can be modified or waived at least to the extent of obligating the lender to give notice of its intent to strictly enforce the parties' contract. *See, e.g.*, Westinghouse Credit Corp. v. Shelton, 645 F.2d 869, 873 (10th Cir. 1981)(citing cases). *But see, Van Bibber*, 419 N.E.2d at 121 ("We consider this approach to be illogical, since the very conduct

yielded the same result without reliance on ambiguous notions of good faith and fair dealing.

Following *K.M.C. Co.*'s lead, other courts have placed a good faith limitation on lenders' discretion to refuse loan advances. For instance, in *Yankton Production Credit Association v. Larson*,⁵⁷ the loan documents provided that advances under a line of credit would be "made at the option of the" lender, that "nothing . . . shall be construed to obligate the [lender] to make loans or advances" and that making advances was "in the absolute discretion" of the lender.⁵⁸ The Larsons claimed that the lender's refusal to make advances necessary to complete the expansion of their farm operations violated the implied covenant of good faith. The trial court entered summary judgment for the lender. On appeal, the Nebraska Supreme Court reversed because the record did not disclose whether the lender's refusal to make further advances "was based on a reasonable, good faith business judgment."⁵⁹

Several recent decisions have refused to follow *K.M.C. Co.* In *Centerre Bank v. Distributors, Inc.*,⁶⁰ a Missouri appellate

which the clause is designed to permit — acceptance of late payment — is turned around to constitute waiver of the clause permitting the conduct."). One of the more significant course of dealing cases is *Alaska Statebank v. Fairco*, 674 P.2d 288 (Alaska 1983). In *Fairco*, the security agreement provided that, if the debtor missed a payment, the lender could accelerate the note and take possession of the collateral securing the note without notice. *Id.* at 289. After the borrowers missed two payments, the parties entered into workout negotiations. During the course of those negotiations, the lender took possession of the collateral without giving notice to the borrower. *Id.* at 290. The court held that the negotiations had effectively modified the security agreement and upheld a verdict for the borrower. *Id.* at 291-93.

The Mississippi Supreme Court held that a lender's acceptance of late payments precluded strict enforcement of a loan agreement without prior notice in *American Nat'l Bank & Trust Co. v. Byrd*, 191 Miss. 457, 467-68, 3 So. 2d 850, 850-52 (1941). Significantly, the court permitted the borrower to recover punitive damages because it characterized the lender's conduct as reckless. *Id.* at 468, 3 So. 2d at 850. The court refused to enforce a provision requiring all contract modifications be in writing in *City of Mound Bayou v. Roy Collins Constr.*, 499 So. 2d 1354, 1357-59 (Miss. 1986). *But see* *Delta Loan & Finance Co. v. Craven*, 231 Miss. 203, 205, 95 So. 2d 105, 105-06 (1957) (enforcing non-waiver provision).

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

⁵⁸ *Id.* at 432.

⁵⁹ *Id.* at 434; *see also* *Carrico v. Delp*, 141 Ill. App. 3d 684, 490 N.E.2d 972, 976 (refusal to lend under discretionary line of credit).

⁶⁰ 705 S.W.2d 42 (Mo. Ct. App. 1985).

court refused to recognize a good faith limitation on a lender's right to call a demand note evidencing a line of credit the bank had granted Distributors, Inc. The note was guaranteed by Mr. and Mrs. Brown, who bought stock in Distributors, Inc. after a loan officer assured them the bank would continue financing the corporation's operations.

Shortly after the Browns purchased their stock, the bank called the demand note.⁶¹ Distributors, Inc. defaulted and Centerre Bank sued to recover a deficiency from the corporation and the Browns.⁶² Relying upon *K.M.C. Co.*, the Browns counterclaimed, contending the bank had accelerated the note in bad faith and thereby violated section 1-208 of the U.C.C. The jury returned a verdict for actual and punitive damages against the bank.⁶³

On appeal, the verdict was reversed because the note was payable "on demand." The court concluded that a demand instrument could be called for whatever reason the lender desired, good or bad, since reading a duty of good faith into the loan agreement added "a term to the agreement which the parties had not included."⁶⁴

⁶¹ *Id.* at 44.

⁶² *Id.* at 46.

⁶³ *Id.* at 44.

⁶⁴ *Id.* at 47, citing *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 269 S.E.2d 916 (1980) and *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wash. App. 530, 518 P.2d 734 (1974), *cert. denied*, 419 U.S. 967 (1974). The court noted that "there was no reason why the obligor on a demand instrument should be entitled to contest the holder's decision to enforce payment when the obligor, by his signature has agreed that his obligation is immediately due and payable." *Centerre Bank*, 705 S.W.2d at 47. The court also noted: "The parties by the demand note did not agree that payment would be made only when demand was made in good faith but agreed that payment would be made whenever demand was made." *Id.* at 48.

Lenders should be aware, however, that the type of demand note construed in *Centerre Bank* has been narrowly construed by other courts. U.C.C. § 3-108 defines demand instruments to "include those payable on sight or on presentation and those in which no time for payment is stated." U.C.C. § 3-108 (emphasis supplied). When the loan documents contain provisions suggesting that the requirement of payment is contingent upon events other than demand, such as a provision providing for acceleration upon certain events of default, some courts have held the note is not a demand instrument and that U.C.C. § 1-208 is applicable. For instance, in *Reid v. Key Bank of Southern Maine, Inc.*, 821 F.2d 9 (1st Cir. 1987), the court held that § 1-208 applied to termination of a \$25,000 line of credit evidenced by a demand note for \$25,000 because (i) the entire \$25,000 had not been drawn, so the face amount of the note could not be due on de-

Centerre Bank's logic was applied by a Florida appellate court in *Flagship National Bank v. Gray Distribution Systems, Inc.*⁶⁵ In *Flagship National Bank*, the parties entered into a workout agreement which provided a line of credit to Gray. As in *Centerre Bank*, the line of credit was evidenced by a demand note. To secure repayment, the agreement required that Gray's operating revenues be deposited into a bank account; the funds deposited into this account were applied against the outstanding loan balance. Gray could not disburse funds from this account without the approval of the bank.⁶⁶

The bank indirectly increased Gray's credit over the ceiling established by the work out agreement by giving Gray's suppliers letters of credit. When Gray's sales declined, the bank refused to issue further letters of credit and insisted that Gray liquidate some of its assets in order to reduce its indebtedness. This liquidation, combined with restrictions on further borrowing, caused Gray's business to deteriorate further. Eventually, the bank called the demand note.⁶⁷

The trial court found that the parties had modified the workout agreement through their course of dealing and that the lender had violated section 1-208 of the U.C.C. by accelerating

mand, (ii) the security agreement provided for acceleration upon the occurrence of events of default, (iii) the note contained provisions governing the acceleration of payment or termination which would "render" the note "payable on demand", and (iv) a bank officer admitted the line-of-credit could not be terminated precipitously. *Id.* at 13-14; see also *Shaughnessy v. Mark Twain State Bank*, 715 S.W.2d 944, 951-52 (Mo. Ct. App. 1986)(references to maturity of note in loan documents, typewritten due date on one note, provision for acceleration on default precludes finding note is payable on demand). A middle course was adopted by the court in *Spencer Companies, Inc. v. Chase Manhattan Bank*, 81 Bankr. 194 (Bankr. D. Mass. 1987)(applying New York law). There the court observed that a pure demand note under U.C.C. 3-108 is immediately payable upon execution without the necessity of a formal demand for payment. However, when the terms of the demand note evidence the debt is not due until a later date (such as a provision providing for the payment of interest at one rate until maturity and then a different rate thereafter), the note is not due until a formal demand for payment is made. Significantly, the court emphatically rejected the borrower's argument that the bank's right to make this formal demand was subject to the obligation of good faith and fair dealing. *Id.* at 198-99.

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

⁶⁶ *Id.* at 1338.

⁶⁷ *Id.* at 1339.

the note in bad faith.⁶⁸ The appellate court rejected the trial court's application of section 1-208 because the note was payable on demand. As in *Centerre Bank*, the court reasoned that an implied obligation of good faith "may not be imposed to override express terms in the [parties'] contract."⁶⁹

Both *Centerre Bank* and *Flagship National Bank* distinguished and criticized *K.M.C. Co.* The court in *Centerre Bank* suggested that *K.M.C. Co.* was limited to situations in which credit was revoked suddenly and without notice.⁷⁰ *Flagship National Bank* pointedly criticized *K.M.C. Co.*'s extension of section 1-208 to demand notes and distinguished *K.M.C. Co.* on the basis that a duty to give notice had arisen during the course of dealing between *K.M.C.* and Irving Trust.⁷¹

The remedial scope of the duty of good faith under Mississippi law has not been fully defined. Most loan agreements are subject to the Mississippi U.C.C.,⁷² which mandates implication of a covenant of good faith.⁷³ In *Black v. Peoples Bank & Trust*

⁶⁸ *Id.* at 1339-40.

⁶⁹ *Id.* at 1340; see also *Brighton Dev. Corp. v. Barnett Bank of South Fla., N.A.*, 513 So. 2d 1103, 1104 (Fla. Dist Ct. App. 1988)(no bad faith in refusing to refund commitment fee since no contractual obligation to extend time for preparing loan documents). A relevant pre-*K.M.C. Co.* case is *Lambert v. Maryland Casualty Co.*, 418 So. 2d 553 (La. 1982). In *Lambert*, the court rejected a contractor's claim that a surety financing the contractor's operations had breached its duty of good faith by refusing, without reasonable notice, to make advances under its loan agreement. *Id.* at 561. The court observed that the loan agreement expressly reserved the surety's right to refuse requests for additional advances and held that good faith did not require the surety "to forbear in the exercise of its rights, contracted at arms length, for its own protection against further liability and loss." *Id.* For an in-depth analysis of *Lambert* and the special legal questions involved in surety financing of their principal's operations, see generally Sneed & Athay, *Ramifications for the Surety-Domination Revisited*, ABA FIDELITY AND SURETY LAW COMMITTEE, CURRENT LEGAL AND ETHICAL SURETYSHIP ISSUES (Jan. 29, 1988), and Schroeder, *Providing Financial Support to the Contractor*, XVII FORUM 1190 (1982).

⁷⁰ *Centerre Bank*, 705 S.W.2d at 48.

⁷¹ *Flagship National Bank*, 485 So. 2d at 1341; see also *Taggart & Taggart Seed, Inc. v. First Tennessee Bank*, No. H-C-87-18 (E.D. Ark. April 15, 1988)(1988 WL 35676)(refusing to impose a good faith limitation on a lender's right to make discretionary advances and call a note on demand); *Spencer Companies, Inc. v. Chase Manhattan Bank*, 81 Bankr. 194, 199 (D. Mass. 1987)(*K.M.C. Co.* misconstrued New York law applicable to demand notes).

⁷² MISS. CODE ANN. § 75-1-101 *et seq.* (1972). Article 3 of the Uniform Commercial Code governs transactions in commercial paper, *Id.* § 75-3-202 *et seq.*, and Article 9 governs secured transactions, *Id.* § 75-9-101 *et seq.*

⁷³ *Id.* at § 75-1-203; see *Wander, Ltd. v. Krouse & Co.*, 368 So. 2d 235, 237 (Miss.

Co.,⁷⁴ the Mississippi Supreme Court adopted the objective test for measuring good faith under section 1-208 of the U.C.C., which applies when a lender accelerates payment under an insecurity clause.⁷⁵ Accordingly, it is clear that under Mississippi law a lender may not accelerate payment of a loan under an insecurity clause unless the lender has a commercially reasonable basis for concluding that its security is impaired.

The Mississippi Supreme Court has not extended the reach of section 1-208 to demand notes, default accelerations or refusals to make discretionary loan advances. Doing so would be inconsistent with the language and intent of section 1-208⁷⁶ and with previous decisions of the court recognizing that the parties to a loan agreement are generally free to define the terms on which acceleration will be permitted. For instance, in *First National Bank v. Caruthers*,⁷⁷ the court held that a covenant permitting acceleration upon sale of mortgaged realty was enforceable, even if for a purpose other than protecting the lender's security interest in the property.⁷⁸ Thus, so long as the lender

1979)(recognizing U.C.C. duty of good faith).

⁷⁴ 437 So. 2d 26 (Miss. 1983).

⁷⁵ *Id.* at 28-29. The court criticized the subjective test "because of the great latitude it gives the creditor and the onerous burden of proof it imposes on the debtor." *Id.* at 29. The court also noted that one of the drafters of the Code, Professor Gilmore, had written that an objective test was required. *Id.* (citing 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 43.4 at 1197 (1965)). Finally, the court observed that Mississippi had applied an objective test in pre-code cases. *Id.* (quoting *Commercial Credit Co. v. Cain*, 190 Miss. 866, 871, 1 So. 2d 776, 777 (1941)).

⁷⁶ The official comment to the section makes it clear that the section is not intended to apply to instruments under which a lender has the discretion to accelerate for any reason: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time or for any reason." U.C.C. § 1-208 comment (emphasis supplied).

⁷⁷ 443 So. 2d 861 (Miss. 1983).

⁷⁸ *Id.* at 862. The issue before the court was the enforceability of a due-on-sale clause which permitted the lender to accelerate if the borrower sold the realty securing his loan. The court rejected the borrower's argument that this clause was unenforceable except for the purpose of protecting the lender's security interest in the project, reasoning: "The right of persons to contract is fundamental to our jurisprudence and absent mutual mistake, fraud and/or illegality, the courts do not have the authority to modify, add to, or subtract from the terms of a contract validly executed between the parties." *Id.* The court rejected an earlier decision, *Sanders v. Hicks*, 317 So. 2d 61 (Miss. 1975), which held that restrictions on alienation are unenforceable except to the extent necessary to protect the lenders' security interest. *Caruthers*, 443 So. 2d at 865. See also John-

deals honestly with the borrower, the U.C.C. duty of good faith should not impede enforcement of the express terms of a loan agreement, unless an insecurity clause is at issue.

Until recently it was unclear whether Mississippi imposed a common law obligation of good faith and fair dealing on contractual relationships. In a 1988 decision, *UHS-Qualicare, Inc. v. Gulf Coast Community Hospital, Inc.*,⁷⁹ the Mississippi Supreme Court recognized the duty of good faith and fair dealing espoused by the Restatement (Second) of Contracts.⁸⁰ Prior to that decision, Mississippi courts had imposed a common law duty of good faith only when a fiduciary relationship⁸¹ or other special circumstances⁸² existed between the contracting parties.⁸³

son v. Stinson, 418 So. 2d 805, 805-06 (Miss. 1982)(permitting acceleration for breach of covenant to obtain insurance); *Universal C.I.T. Credit Corp. v. Rhodes*, 237 Miss. 455, 462-63, 115 So. 2d 160, 163-64 (1959)(enforcement of pre-U.C.C. contract providing for acceleration upon default in payment). Other courts have rejected the application of § 1-208 to due-on-sale clauses, e.g., *Crockett v. First Federal Savings & Loan Ass'n of Charlotte, N.C.*, 289 N.C. 620, 224 S.E. 2d 580, 588 (1976), and other default acceleration provision; see, e.g., *Westland v. Melson*, 647 S.W.2d 488, 490 (Ark. Ct. App. 1983).

⁷⁹ 525 So. 2d 746 (Miss. 1988).

⁸⁰ *Id.* at 757 n. 8. The issue in *UHS-Qualicare, Inc.*, was whether a material breach had occurred justifying termination of a contract for default when the terminating party had the power to cure the breach itself. *Id.* at 755. The court's reference to the duty of good faith was not essential to its holding.

⁸¹ See, e.g., *Walker v. U-Haul Co. of Miss.*, 734 F.2d 1068, 1075 (5th Cir. 1984)(recognizing duty in a fiduciary relationship); *Carter Equip. Co. v. John Deere Indus. Equip. Co.*, 681 F.2d 386, 392 (5th Cir. 1982)(same).

⁸² The Mississippi Supreme Court had held that a contracting party must act in good faith when its duty to perform is contingent on its acceptance or rejection of the other party's performance. See, e.g., *Ford v. Lamar Life Ins. Co.*, 513 So. 2d 880, 887 (Miss. 1987)(determining compliance with conditions set forth in premium receipt for life insurance); *City of Mound Bayou v. Roy Collins Constr.*, 499 So. 2d 1354, 1357-59 (Miss. 1986)(design professional must act in good faith in reviewing pay requests by contractor); cf. *Ard Dr. Pepper Bottling Co. v. Dr. Pepper Co.*, 202 F.2d 372, 376 (5th Cir. 1953)(construing clause permitting termination if determination of non-compliance made in good faith). Lenders frequently must determine whether their borrowers have complied with condition precedents for making a loan or future advances under a loan. See, e.g., *Consolidated Am. Life Ins. Co. v. Covington*, 297 So. 2d 894, 898 (Miss. 1984)(compliance for jury to decide).

In addition, the Mississippi Supreme Court had held that oil and gas operators under mineral leases have an implied duty to act as a prudent operator and to deal in good faith, fairly and equitably with royalty owners. *Continental Oil Co. v. Blair*, 397 So. 2d 538, 543 (Miss. 1981).

⁸³ Prior to *UHS-Qualicare, Inc.*, most authorities had concluded that Mississippi

Mississippi cases emphasize that the obligation of good faith and fair dealing does not limit a party's right to take action expressly authorized by its contract. Unless the contractual terms are unconscionable or illegal, even a fiduciary is entitled to enforce its contract as written and the duty of good faith yields to the rights granted by the agreement.⁸⁴ The application of this principle is illustrated by *Walker v. U-Haul Co.*⁸⁵ In *Walker*, the parties' franchise agreement permitted termination of the relationship, without cause, upon written notice. Despite the arguable existence of a fiduciary relationship between the parties, the court noted that the contract permitted termination for any reason and hence the duty of good faith did not preclude "act[ing] arbitrarily in terminating a business relationship . . . if arbitrariness is authorized by a contractual provision."⁸⁶ In so holding, the court apparently aligned Mississippi with the Texas rule —

did not impose a common law duty of good faith and fair dealing on every contract relationship. Freeland & Freeland, *Bad Faith Litigation: A Practical Analysis*, 53 Miss. L.J. 237, 238 n.8 (1983)(under Mississippi law, duty to act in good faith "does not apply to every contract")(emphasis added); see *Carter Equip. Co. v. John Deere Indus. Equip. Co.*, 681 F.2d 386, 392 n.12 (5th Cir. 1982)("Good faith and fair dealing are not customarily equated with a fiduciary duty. Mississippi, however, seems to merge the two concepts, at least in a broad sense."); *Davidson v. State Farm Fire & Casualty Co.*, 641 F. Supp. 503, 514 (N.D. Miss. 1986)("[T]he Mississippi Court has not ruled on the existence of a duty of good faith and fair dealing *per se*," but has declined to impose the duty on nonfiduciaries.). There were scattered references to a general duty of good faith in other published Mississippi decisions, however. For instance, in *Olin Corp. v. Central Industries, Inc.*, 576 F.2d 642 (5th Cir. 1979), the court referred to "the policy of Mississippi statutes requiring good faith and honesty in dealing." *Id.* at 648. The court cited to the good faith section of the Mississippi U.C.C. *Id.* at 648 n.9 (citing Miss. Code Ann. § 75-1-203 (1972)). The court also noted that *Darden v. American Bank and Trust Co.*, 158 Miss. 742, 748, 130 So. 507, 509 (1930), cited 13 C.J. *Contracts* § 254 at 542-544 (1939) which states that every contract requires a covenant of good faith and fair dealing. *Olin Corp.*, 576 F.2d at 648 n.9. However, *Darden* did not quote, explain or otherwise rely on the cite for its holding. See also, *Bank of Ind. v. Holyfield*, 476 F.Supp. 104, 109 (S.D. Miss. 1979)(Mississippi law requires "good faith and fundamental fairness in the performance of every contract.")(dictum).

⁸⁴ See *Jackson Rapid Delivery Serv., Inc. v. Jones Truck Lines, Inc.*, 641 F. Supp. 81, 85-86 (S.D. Miss. 1986)(contract definition of duties of parties supplants fiduciary duties of good faith and fair dealing unless contract unconscionable); see also *Shaw v. Burchfield*, 481 So. 2d 247, 252-54 (Miss. 1985)(enforcing clause in employment contract providing for termination upon 10 days notice without cause).

⁸⁵ 734 F.2d 1068 (5th Cir. 1984).

⁸⁶ *Id.* at 1075; see also *Duncan v. Coahoma Bank*, 397 So. 2d 891, 894 (Miss. 1981)(no liability for lender's allegedly tortious exercise of contract right).

"[t]here can be no implied covenant [of good faith] as to a matter specifically covered by the written terms of the contract."⁸⁷ Under this principle, the duty of good faith only regulates the conduct of the parties regarding matters the contract does not specifically address.⁸⁸

Mississippi should continue to allow lenders to control their risks by negotiating loan agreements that empower them to take the steps necessary to salvage their losses when a loan goes sour.⁸⁹ Superimposing an ambiguous duty of fairness on the lenders' right to exercise its contractual powers would destroy the certainty and predictability of legal rights necessary for commercial loan transactions.⁹⁰

B. *Fiduciary Duty*

A second theory used by borrowers to impose liability on lenders is the breach of fiduciary obligations. Commercial relationships ordinarily involve parties with competing interests. The parties deal at arms' length and admittedly watch out for their own interests. No party need place any other party's inter-

⁸⁷ See *Exxon Corp. v. Atlantic Richfield Co.*, 678 S.W.2d 944, 947 (Tex. 1984)(citation of Texas rule); see also *McPherson v. Gullett Gin Co.*, 134 Miss. 771, 100 So. 16, 18 (1924)(if contract states duties and liabilities of parties, contract governs and no other duty is implied). Texas has adopted U.C.C. §§ 1-203 and 1-208, which require honesty in fact in the performance of contracts subject to its terms. TEX. BUS. & COM. CODE ANN. §§ 1.203, 1.208 (Vernon 1968). The Texas Supreme Court has refused, however, to recognize the RESTATEMENT (SECOND) OF CONTRACTS heightened duty of "good faith and fair dealing." See *English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983)(All contracts do not contain "an implied covenant of 'good faith and fair dealing' that neither party will do anything which injures the right of the other party to receive the benefits of the agreement."); Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411, 423 (1987)("[T]he implied duty in Texas will be applied in interpreting contracts, but not to contradict the express terms of a contract."); *W.F. Thompson v. M & B Constr. Corp.*, 585 F. Supp. 561, 563 (N.D. Tex. 1984)(same); accord *Cluck v. First Nat'l Bank*, 714 S.W.2d 408, 410 (Tex. Ct. App. 1986)(same).

⁸⁸ Tyler, *supra* note 87, at 418 (using duty of good faith to overcome express contract terms "calls into question the validity of all such contracts, while simultaneously depriving parties and their counsel of the guidance available from case law existing under traditional theories.").

⁸⁹ See *Sneed & Athay*, *supra* note 69, at 18.

⁹⁰ *Id.*; see also *Warren*, *supra* note 42, at 58 ("Good faith under the U.C.C. is a loose cannon and may be used by courts to further their view of justice.").

est above his own.⁹¹

Fiduciary relationships are different. A fiduciary acts for the benefit of others on matters within their relation.⁹² When a conflict arises, the fiduciary must act in good faith to protect the other parties' interests, even at the expense of his own. Special duties of disclosure,⁹³ loyalty⁹⁴ and stewardship⁹⁵ spring from the relationship.⁹⁶

⁹¹ See *Haroco, Inc. v. American Nat'l Bank and Trust Co.*, 647 F.Supp 1026, 1035 (N.D. Ill. 1986) ("The parties are businesses presumably dealing at arms length. Their relationships were governed by contracts. In short, they enjoyed no more than customary business relationships.")

⁹² See, e.g., *Wright v. Bayly Corp.*, 587 P.2d 799, 801 (Colo. Ct. App. 1978) (citing RESTATEMENT (SECOND) OF TRUSTS § 2 comment b); *Kurth v. Van Horn*, 380 N.W.2d 693, 695 (Iowa 1986) (citing RESTATEMENT (SECOND) OF TORTS § 874 comment a) ("fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation."); RESTATEMENT (SECOND) OF TRUST § 2 comment b (1959) (fiduciary is "under a duty to act for the benefit of the other as to matters within the scope of the relation."); RESTATEMENT (SECOND) OF TORTS § 874 comment a (1979).

⁹³ See RESTATEMENT (SECOND) OF TRUSTS § 170(2) (1959) (full disclosure required by fiduciary of all facts pertaining to transaction).

⁹⁴ The duty of loyalty embraces the concept that a fiduciary may not profit at the expense of his beneficiary and may not enter into competition with him without his consent. See RESTATEMENT (SECOND) OF TRUSTS § 2 comment b (1959) (discussion of duty of loyalty). The most widely quoted formulation of the duty of loyalty is contained in Chief Judge Cordoza's opinion in *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928):

Many forms of conduct permissible in a work a day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Meinhard, 164 N.E. at 546. For a discussion of the duty of loyalty imposed upon directors and officers of corporations under Mississippi law, see *Keker & Hunt, Fiduciary Relationships in a Business Setting in Business Torts*, 38 MISS. L. INST. 25, 28-38 (1983).

⁹⁵ See, e.g., *First Alabama Bank v. Spragins*, 475 So. 2d 512, 516 (Ala. 1985) (trustee has duty to exercise such care and skill as man of ordinary prudence would exercise; citing RESTATEMENT (SECOND) OF TRUSTS § 174); see also *Wilcox v. St. Croix Labor Union Mut. Homes, Inc.*, 567 F. Supp. 924, 935 (D.C. V.I. 1983) (citing RESTATEMENT (SECOND) OF AGENCY § 379); *Davis v. Miller Builders & Developers, Inc.*, 340 So. 2d 409, 413 (La. Ct. App. 1976) (same).

⁹⁶ See Note, *Trust and Confidence and the Fiduciary Duty of Banks in Iowa*, 35

Certain kinds of relationships are inherently fiduciary in nature. For this reason, attorneys, agents, trustees and partners are considered fiduciaries as a matter of law.⁹⁷

Fiduciary relationships can also arise in commercial transactions if the circumstances justify making an exception to the usual rule that the parties to a commercial transaction must protect their own interests.⁹⁸ Although it is clear that mere friendship or confidence,⁹⁹ a good working relationship¹⁰⁰ or acting in an advisory capacity,¹⁰¹ without more, does not create a fiduciary relationship, no single standard has been formulated for determining when the relationship actually arises.¹⁰²

DRAKE L. REV. 611, 612 (1985-86) ("Fiduciary breach generally takes one of three forms: breach of the duty of disclosure, loyalty or stewardship.").

⁹⁷ See J. POMEROY, EQUITY JURISPRUDENCE § 956(a) at 793-95 (5th ed. 1941) (analyzing categories of fiduciary relationships). One commentator reasoned that the court imposes fiduciary concepts in these kinds of relationships on a per se basis because "the factors that give rise to a fiduciary duty are present in the vast majority of these relationships" and "a per se approach saves the parties the trouble of expressing or negotiating their respective rights and eliminates difficult factual determinations in the event of litigation." Clarke, *The Fiduciary Obligations of Lenders in Leveraged Buyouts*, 54 MISS. L.J. 423, 427 (1984).

⁹⁸ Note, *The Fiduciary Controversy: Injection of Fiduciary Principles into the Bank-Depositor and Bank-Borrower Relationships*, 20 LOY. L.A.L. REV. 794, 798 (1987) (citing *World Vision Enter., Inc. v. American Broadcasting Co.*, 142 Cal. App. 3d 589, 594, 191 Cal. Rptr. 148, 151 (1983)).

⁹⁹ See *Wilson v. Zorb*, 15 Cal. App. 2d 526, 532, 59 P.2d 593, 596 (1936) ("It takes something more than friendship or confidence in the professional skill and the integrity and truthfulness of another to establish a fiduciary relationship."); *Franz v. Porter*, 132 Cal. 49, 51, 64 P. 92, 94 (1901) (warm personal friendship not sufficient to establish fiduciary relationship).

¹⁰⁰ See *Reid v. Key Bank of Southern Maine, Inc.*, 821 F.2d 9, 17 (1st Cir. 1987) (affirming dismissal of claim of breach of fiduciary duty); *Horoco, Inc. v. American Nat'l Bank & Trust Co.*, 647 F. Supp. 1026, 1035 (N.D. Ill. 1986) (mere trust to perform contract insufficient).

¹⁰¹ See *Snow v. Merchants Nat'l Bank*, 35 N.E.2d 213, 217 (Mass. 1941) (advice given in business relation does not create fiduciary relationship); *Umbaugh Pole Bldg. Co. v. Scott*, 58 Ohio St. 2d 282, 390 N.E.2d 320, 323 (1979) (absent demonstrations of trust relationship, lender does not have fiduciary duty to its borrower even if advice is offered).

¹⁰² See Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW 883, 886 (1976) (considers case law hopelessly confused); Wolenski & Econome, *Seduction in Wonderland, A Need for a Seller's Fiduciary Duty Toward Children*, 4 HASTINGS CONST. L.Q. 249, 265 (1977) (comments that courts have failed to articulate adequate fiduciary theories). For a discussion of the various theories upon which fiduciary obligations have been based, see Shepherd, *Towards a Unified Concept of Fiduciary*

The most commonly applied standards are the trust theory and the domination theory. Under the trust theory, a fiduciary relationship arises when one party justifiably reposes trust and confidence in the other and the other party knows or accepts the trust and confidence.¹⁰³

Under the domination theory, a fiduciary relationship may arise if one party sufficiently dominates and controls the other.¹⁰⁴ The mere existence of unequal bargaining positions, however, is not sufficient domination to create a fiduciary relationship.¹⁰⁵

Some courts, including Mississippi, intertwine the trust and domination concepts in determining whether a fiduciary relationship exists.¹⁰⁶ When dependency or control exists, it is more reasonable to assume that the parties intended to impose fiduciary restraints on the dominant party.¹⁰⁷ As will be discussed later, the issue of control is particularly crucial in cases in which third party creditors seek to impose liability upon lenders for corporate debts.¹⁰⁸

Lenders are not fiduciaries *per se*.¹⁰⁹ The commercial inter-

Relationships, 97 LAW Q. REV. 51, 53-71 (1981).

¹⁰³ See *Committee on Children's Television v. General Foods Corp.*, 35 Cal. 3d 197, 673 P.2d 660, 675-76, 197 Cal. Rptr. 783, 798 (1983)(fiduciary must have knowingly undertaken to act, advise with the beneficiary's interest in mind); *Kurth v. Van Horn*, 380 N.W.2d 693, 695-96 (Iowa 1986)(A fiduciary "relationship exists when there is a reposing of faith, confidence and trust, and the placing of reliance by one upon the judgment and advice of the other."; quoting BLACK'S LAW DICTIONARY 563 (5th Ed. 1979)).

¹⁰⁴ See *infra* note 306 and accompanying text.

¹⁰⁵ See, e.g., *Carter Equip. Co. v. John Deere Industrial Equip. Co.*, 681 F.2d 386, 391 n.10 (5th Cir. 1982)("Without other contributing factors, inequality does not give rise to a fiduciary relationship.").

¹⁰⁶ E.g., *Carter Equip.*, 681 F.2d at 390-91 (fiduciary relationship arises under Mississippi law where parties share common interest in success of enterprise, trust is justifiably reposed, fiduciary dominates non-fiduciary); *Klein v. First Edina Nat'l Bank*, 293 Minn. 418, 196 N.W.2d 619, 623 (1972)(fiduciary relationship exists when one party places justifiable trust in another, other knows and accepts trust, trusting party's capacity to protect his own interests is diminished).

¹⁰⁷ See *Carter Equip.*, 681 F.2d at 391 ("If the franchisor has power to control the franchisee, there is an increased likelihood that a fiduciary relationship exists, since trust or confidence necessarily must flow from the controlled or dominated party.").

¹⁰⁸ See *infra* notes 297-348 and accompanying text.

¹⁰⁹ See, e.g., *In re Letterman Bros. Energy Securities Litig.*, 799 F.2d 967, 976 (5th Cir.)(no general fiduciary relation between borrower, lender), *cert. denied*, 107 S.Ct. 1373 (1986); *In re W.T. Grant Co.*, 699 F.2d 599, 609-10 (2d Cir. 1983)(no fiduciary duty in

ests of lenders and borrowers are different and usually adverse to one another.¹¹⁰ The primary concern of each is its own interests, not the interests of the other.¹¹¹ Borrowers seek the lowest possible interest rate and the least restrictive payment and security terms. In contrast, lenders seek the highest possible return and as much security as the borrower can provide.¹¹² The conflicting interests of the lender and borrower are especially apparent in security agreements. Both lender and borrower recognize the object of the security agreement is to protect the lender by empowering it to act before the value of the lender's security is lost.¹¹³

Nevertheless, claims of fiduciary breach are frequently asserted against lenders. These claims usually fail because the borrower cannot show that he justifiably reposed trust in the lender¹¹⁴ or that the lender knowingly accepted the trust reposed, elements required by the majority of courts.¹¹⁵ Recently, however, courts in California¹¹⁶ and Florida¹¹⁷ have suggested

collection of claim), *cert. denied*, 464 U.S. 822 (1983); *Haroco, Inc. v. American Nat'l Bank & Trust Co.*, 647 F.Supp 1026, 1035 (N.D. Ill. 1986)(debtor-creditor relationship not fiduciary in character); *Delta Diversified, Inc. v. Citizens & S. Nat'l Bank*, 171 Ga. App. 625, 320 S.E.2d 767, 776 (1984)(no confidential relationship between bank, its borrowers); *Umbaugh Pole Bldg., Co. v. Scott*, 58 Ohio St. 2d 282, 286, 390 N.E.2d 320, 321 (1979)(relationship of debtor, creditor without more is not fiduciary relationship).

¹¹⁰ See *Weinberger v. Kendrick*, 698 F.2d 61, 79 (2d Cir. 1982)(It "would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table."), *cert. denied*, 464 U.S. 818 (1983); *First Am. Nat'l Bank v. Mitchell*, 359 So. 2d 1376, 1380 (Miss. 1978)(The relationship "was adverse so far as payment of the debt was concerned. . .").

¹¹¹ See Note, *supra* note 98, at 799.

¹¹² *Id.* at 824.

¹¹³ See *Sneed & Athay*, *supra* note 69, at 76 ("Since, the lender's primary goal is to obtain adequate security to cover its loan, it obtains contractual rights which will protect the value of the security and facilitate for closing on it.")

¹¹⁴ See, e.g., *Denison State Bank v. Madeira*, 230 Kan. 684, 640 P.2d 1242, 1245 (1982)(borrower could easily discover problem from its records); *Stenberg v. Northwestern Nat'l Bank of Rochester*, 307 Minn. 487, 238 N.W.2d 218, 219 (1976)(borrower was "capable of independent judgment").

¹¹⁵ See, e.g., *Denison*, 640 P.2d at 1244 (one may not unilaterally impose fiduciary duties on another); *Klein v. First Edina Nat'l Bank*, 293 Minn. 418, 196 N.W.2d 619, 621-22 (1972)(There was "no evidence in the record to indicate that defendant ought to have known that plaintiff was placing her trust and confidence in defendant and was depending upon defendant to look out for her interests.")

¹¹⁶ See *infra* notes 140, 149-151 and accompanying text.

¹¹⁷ See *infra* notes 140-148 and accompanying text.

that lenders may have special disclosure obligations when they stand to benefit at a customer's expense, even if the traditional elements of a trust relationship are absent.

In the California case, *Barrett v. Bank of America*,¹¹⁸ a bank allegedly reneged on an oral promise to release the personal guarantees of the Barretts when their corporation merged with another company. Shortly after the merger, the corporation filed bankruptcy and the bank assigned the guarantees to the Small Business Administration (SBA), which had insured the loan. The Barretts had to use the proceeds derived from selling their home to satisfy demands made by the SBA on the basis of the personal guarantees. They then sued the bank for, among other things, fraud.¹¹⁹

The trial court concluded that the Barretts were not entitled to recover for fraud because the jury found in favor of the bank on the element of scienter.¹²⁰ On appeal, the Barretts complained that the trial court should have given the jury an instruction on "constructive fraud", defined by the appellate court as being a breach of duties arising from a relationship of trust or confidence, without fraudulent intent.¹²¹

To apply the constructive fraud doctrine, the court had to find that a confidential relationship existed between the bank and the guarantors. Initially, the court noted confidential and fiduciary relationships are legally synonymous¹²² and exist

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

¹¹⁹ *Id.* at 17-18.

¹²⁰ *Id.* at 19. In response to special interrogatories, the jury concluded that the guarantors reasonably believed their guarantees would be released and that the lender's loan officer promised they would be released at or after consummation of the merger. The jury also found, however, that the loan officer's promise was warranted by the information known to him. Accordingly, the trial court concluded that the plaintiffs had not proven the scienter required to find fraud. *Id.*

¹²¹ *Id.* at 20. The court explained:

In its generic sense, constructive fraud comprises all acts, omissions and concealments involving a breach of legal or equitable duty, trust, or confidence, and resulting in damages to another. Constructive fraud exists in cases in which conduct, although not actually fraudulent, ought to be so treated — that is, in which such conduct is a constructive or quasi fraud, having all the legal effects of actual fraud. Constructive fraud usually arises from a breach of duty where a relation of trust and confidence exists.

Id.

¹²² *Id.* One commentator, however, has noted the following distinction between the

"whenever trust and confidence is reposed by one person in another."¹²³ The court then observed that the relationship between a bank and its depositor is quasi-fiduciary in nature,¹²⁴ a conclusion the court erroneously suggested was supported by decisions from other jurisdictions.¹²⁵ Turning to the facts, the court reasoned that the requisite trust and confidence existed, at least to some degree, between the Barretts and the bank¹²⁶ since the Barretts testified that they had a close relationship with the

relationships:

The distinguishing feature between fiduciary and confidential relations seems to be that the confidential relation concept is a creation of a felt need for restitution where courts believe they cannot find a contract. Fiduciary cases, as with bargained for exchange cases, will protect the expectation interest; the confidential relation cases often seem only to protect the reliance or restitution interests.

Symons, *The Bank-Customer Relation: Part 1 - The Relevance of Contract Doctrine*, 100 BANKING L.J. 220, 235 (1983).

¹²³ *Barrett*, 229 Cal. Rptr. at 20.

¹²⁴ *Id.* The court relied upon its holding in *Commercial Cotton Co. v. United Calif. Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554 (1985), discussed *infra* notes 128-132 and accompanying text.

¹²⁵ "Other jurisdictions recognize a similar relationship of trust and confidence exists between a bank and its loan customers which gives rise to a duty of disclosure of facts which may place the bank or a third party at an advantage with respect to the customer." *Barrett*, 229 Cal. Rptr. at 20, *citing* *Klein v. First Edina Nat'l Bank*, 293 Minn. 418, 196 N.W.2d 619 (1972), *First Nat'l Bank v. Brown*, 181 N.W.2d 178 (Iowa 1970), and *Stewart v. Phoenix Nat'l Bank*, 49 Ariz. 34, 64 P.2d 101 (1937). The *Klein* court held that a lender had no fiduciary duty to disclose to a person providing security for a new note that the borrower had an earlier loan and that the collateral being provided would secure both notes. Even though the plaintiff testified she was a long-time customer and trusted the bank like she would her doctor or lawyer, the court concluded no fiduciary relationship existed because there was no evidence the bank knew or should have known the plaintiff expected the bank to protect her interest. *Klein*, 64 P.2d at 623. Since no such evidence was introduced in *Barrett* either, its reliance on *Klein* is anomalous. The *Brown* and *Stewart* decisions provide thin support for the *Barrett* holding. In *Brown*, the court held that a party in a position of trust, with superior knowledge of the facts, must disclose all material facts he is aware of. However, the court based its holding on a theory of fraud, not breach of fiduciary duty. *Brown*, 181 N.W.2d at 184. *Stewart* also involved a claim of actual fraud. In holding for the plaintiff, the court held that the relation between the plaintiff and the bank "was far beyond that of a mere debtor and creditor and that because of changes in the banking industry the plaintiff had to rely upon the bank to give advice in good faith." *Stewart*, 64 P.2d at 106. The *Stewart* court did not use the word fiduciary; however, the dealings between the parties recited by the court suggest that the mutuality required in *Klein* — trust and knowledge of the trust — was present. *Id.* at 104-06.

¹²⁶ *Barrett*, 229 Cal. Rptr. at 20-21.

bank, had relied upon the bank's advice and had shared confidential information with the bank.¹²⁷ Interestingly, no evidence was presented to demonstrate that the bank knew of or accepted the Barrett's trust.

The court relied on its earlier decision in *Commercial Cotton Co. v. United California Bank*¹²⁸ in concluding that the bank-depositor relationship was at least quasi-fiduciary. The issue in *Commercial Cotton* was whether a depositor could recover in tort as well as in contract for breach of the covenant of good faith and fair dealing.¹²⁹ The bank argued that under California law, a "special relationship" must exist before a tort action would arise. The court agreed¹³⁰ but found that a "special relationship" existed because the bank-depositor relationship involved elements of "public interest, adhesion, and fiduciary responsibility."¹³¹ The court compared the banking industry to the insurance industry, noting both were highly regulated and both performed a vital public service. Since insurance companies were liable in tort for breach of the implied covenant of good faith and fair dealing, the court concluded that banks should be also.¹³²

¹²⁷ *Id.*

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

¹²⁹ The case arose from the wrongful payment of a check. The depositor had notified the bank of missing checks. Several years later one of the missing checks, bearing an unauthorized signature, was negotiated. Eighteen months later, the depositor demanded his account be recredited. The bank refused, arguing the statute of limitations had run. In a previous case involving the same bank, the California Supreme Court had held that the statute of limitations in question was inapplicable to negligence claims. Accordingly, the plaintiff contended the bank had acted in bad faith since it refused to recredit the funds despite the bank's actual knowledge of the court's prior ruling. *Commercial Cotton*, 209 Cal. Rptr. at 554.

¹³⁰ The court relied on *Seamen's Direct Buying Serv., Inc. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984), in which the California Supreme Court held that a claim for tortious breach of the covenant of good faith and fair dealing can be asserted if the breach arises in connection with a special relationship like that of insured-insurer or when a party denies, in bad faith, the existence of a contract or raises similar spurious defenses to liability. *Id.* at 1167, 206 Cal. Rptr. at 363. The *Commercial Cotton* court held that the bank's statute of limitation defense was similarly spurious. *Commercial Cotton*, 209 Cal. Rptr. at 554.

¹³¹ *Commercial Cotton*, 209 Cal. Rptr. at 554.

¹³² *Id.* California imposes tort liability upon insurers for breach of the covenant of good faith and fair dealing. See *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78, 93 (1970)(disability insurance policy). For a discussion of the im-

The *Commercial Cotton* and *Barrett* decisions are the first to suggest that the relationship between a bank and its depositors is "quasi-fiduciary."¹³³ Other jurisdictions generally agree that the bank-depositor relationship, like the bank-borrower relationship, is a debtor-creditor relationship in which each party is responsible for his own interests.¹³⁴

The Florida Supreme Court imposed fiduciary obligations on a lender in *Barnett Bank v. Hooper*.¹³⁵ In *Barnett Bank*, the bank owed conflicting duties to two customers. Hooper, a long time bank customer, borrowed money from the bank which he deposited in the account of Mr. Hosner, also a bank customer. At the time this loan was made, the bank suspected Hosner of being involved in a check-kiting scheme. Because of Hooper's deposit, the bank was able to zero-out Hosner's account when the check-kiting scheme was later confirmed.¹³⁶

Hooper sued for rescission of his loans, contending the bank had breached a fiduciary duty in failing to disclose its suspicions.¹³⁷ Utilizing the trust theory, the court concluded that the bank-borrower relationship required a bank to disclose material facts known only to the bank if the bank could possibly benefit

sition of tort liability for breach of the duty of good faith, see *supra* note 26.

¹³³ See Note, *supra* note 98, at 814 (*Commercial Cotton* "unparalleled and unsupported").

Authors' note: A claim of constructive fraud premised on the existence of a fiduciary relationship between borrowers and their bank lender was rejected by a California appellate court in *Kruse v. Bank of America*, to be reported in 201 Cal. App. 3d 354, 248 Cal. Rptr. 217 (1988), which was decided after this article was submitted to the printer. The court refused to navigate what it described as the "murky waters" of *Commercial Cotton*. Instead, the court relied on the failure of the borrowers and guarantors to prove justifiable reliance on statements made by the bank officer to overturn a 146 million dollar verdict.

¹³⁴ See, e.g., *Bank of Marin v. England*, 385 U.S. 99, 101 (1966) (The "relationship of bank and depositor is that of debtor and creditor founded upon contract."); *Manson State Bank v. Tripp*, 248 N.W.2d 105, 108 (Iowa 1976) (no confidential relationship); *Dugan v. First Nat'l Bank*, 227 Kan. 2d, 606 P.2d 1009, 1014 (1980) (relationship of debtor-creditor not fiduciary); *Klein v. First Edina Nat'l Bank*, 293 Minn. 418, 422, 196 N.W.2d 619, 622 (1972) (bank-borrower relationship is not confidential relationship); *Deposit Guar. Bank & Trust Co. v. Merchants Bank & Trust Co.*, 171 Miss. 553, 558, 158 So. 136, 137-38 (1934) (deposit not trust fund).

¹³⁵ 498 So. 2d 923 (Fla. 1986).

¹³⁶ *Id.* at 924.

¹³⁷ *Id.* at 924.

at the expense of the borrower.¹³⁸

A persuasive dissent pointed out that the evidence did not show that the borrower had justifiably relied on the bank or that the bank had accepted such reliance.¹³⁹

The most frequently cited case in support of the majority approach requiring proof of these elements is the Minnesota Supreme Court's decision in *Klein v. First Edina National Bank*.¹⁴⁰ Klein, a long time bank customer, pledged stock to secure a loan to her employer. When this pledge was made, Klein was not aware that the employer owed money on an earlier loan and that the bank wanted Klein's stock as security for both loans. When the bank foreclosed on the stock, Klein sued, alleging that the bank's failure to disclose the earlier loan constituted fraud.¹⁴¹ In considering this claim, the court acknowledged that a lender ordinarily is not a fiduciary of its borrower and thus has no special disclosure obligations. The court concluded, however, that a special relationship requiring disclosure may arise when "the bank knows or has reason to know that the customer is placing his trust and confidence in the bank and is relying on the bank so to counsel and inform him."¹⁴² Klein testified she had been a customer of the bank for twenty years and that she trusted the bank's representative; but no evidence was introduced to demonstrate the lender knew or should have known of this trust. Accordingly, the court held no fiduciary relationship existed.¹⁴³

In *Denison State Bank v. Madeira*,¹⁴⁴ the court rejected a borrower's claim that the bank breached its fiduciary obligation

¹³⁸ *Id.* at 925. The bank contended it would have breached the duty of confidentiality it owed Hosner if it had disclosed its suspicions. The court created a "special circumstances" exception to the duty of confidentiality permitting disclosure where the bank, having actual knowledge of a fraud, enters into a transaction with a customer in furtherance of the fraud or when the bank has a fiduciary relationship with the customer to whom the disclosure is made. The other exceptions enumerated include compulsion of law, public interest, bank's interest, express or implied consent. *Id.*

¹³⁹ *Id.* at 926 (Boyd, J., dissenting); see also *supra* notes 142, 154 and accompanying text.

¹⁴⁰ 293 Minn. 418, 196 N.W.2d 619 (1972).

¹⁴¹ *Id.* at 621.

¹⁴² *Id.* at 623.

¹⁴³ *Id.*

¹⁴⁴ 230 Kan. 684, 640 P.2d 1235 (1982).

by failing to disclose the financial problems of another bank customer's automobile dealership. Madeira invested in the dealership and entered into a loan agreement with the bank.¹⁴⁵ The bank failed to disclose all of the facts in its possession about the dealership's financial condition, including the fact that certain assets had been pledged to another creditor.¹⁴⁶ The court concluded that the imposition of a fiduciary duty on the bank was inappropriate because Madeira was capable of discovering the dealership's financial problems from the dealership's records¹⁴⁷ and because the bank had not consciously assumed the fiduciary duties Madeira sought to impose on it.¹⁴⁸

Failure to demonstrate justifiable reliance contributed to the reversal of the multimillion dollar damage award in *Centerre Bank*.¹⁴⁹ The court rejected the Browns' claim that the bank breached a fiduciary duty by failing to disclose that Distributors, Inc.'s debt had been classified as a problem loan.¹⁵⁰ The evidence established that one of the Brown family members managed Distributors, Inc., that the Browns all knew of Distributors, Inc.'s financial difficulties, and that the financial information the bank had relied upon in classifying the loan was readily available to the Browns. Accordingly, the court held that the Browns had no right to depend upon the bank to disclose information about the classification of Distributors, Inc.'s loan.¹⁵¹

Mississippi courts have held that a fiduciary relationship may arise in commercial transactions when the circumstances establish that (i) the parties have "shared goals" in each other's commercial activity, (ii) one party justifiably places trust or confidence in the integrity and fidelity of the other, and (iii) the

¹⁴⁵ *Id.* at 1239.

¹⁴⁶ *Id.* at 1243.

¹⁴⁷ *Id.* at 1245.

¹⁴⁸ *Id.* at 1244. The court observed that a lender ordinarily does not owe a fiduciary obligation to its borrower, noting: "[O]ne may not abandon all caution and responsibility for his own protection and unilaterally impose a fiduciary relationship on another without a conscious assumption of such duties by the one sought to be held liable as a fiduciary." *Id.* at 1243-44.

¹⁴⁹ 705 S.W.2d 42 (Mo. Ct. App. 1985). See *supra* notes 60-64 and accompanying text for a discussion of the facts in *Centerre Bank*.

¹⁵⁰ *Centerre Bank*, 705 S.W.2d at 52.

¹⁵¹ *Id.* at 52-53.

trusted party has effective control over the other party.¹⁵² When these criteria are satisfied, a duty of "good faith and fair dealing" arises which bars the fiduciary from using its power to destroy, injure or gain a preferential advantage over the weaker party or to frustrate the weaker party's legitimate commercial expectations.¹⁵³ Even this duty, however, yields to the express rights granted to the fiduciary in the parties' contract, provided the contractual terms are not illegal or unconscionable.¹⁵⁴

The lender-borrower relationship does not fit the criteria outlined above. The lender and borrower are not involved in the same business activity; their interests are fundamentally different. As noted earlier, neither has a justifiable basis for concluding that the other is watching out for its interests; the relationship is arms-length.¹⁵⁵ Most importantly, the lenders' apparently superior bargaining position does not deprive the borrower of his capacity to act independently; the borrower remains free to take his business elsewhere.¹⁵⁶

The Mississippi Supreme Court has recently made apparently conflicting statements about the lender-borrower relationship. In a 1986 case, *West Point Corp. v. New North Mississippi Federal Savings & Loan Association*,¹⁵⁷ the court cited with approval a New Mexico decision, which held that a lender does not

¹⁵² *Carter Equip. Co. v. John Deere Indus. Equip.*, 681 F.2d 386, 390-91 (5th Cir. 1982). For a discussion of the *Carter Equip.* decision, see Kecker & Hunt, *supra* note 94, at 38-42.

¹⁵³ *Carter Equip.*, 681 F.2d at 392.

¹⁵⁴ See *supra* notes 84-88 and accompanying text.

¹⁵⁵ See *supra* notes 109-115 and accompanying text.

¹⁵⁶ Domination and dependency are essential to a finding of a fiduciary relationship. In determining control, one key is whether the less powerful party retained its freedom to protect its interest by contracting with others. See *Jackson Rapid Delivery Serv., Inc. v. Jones Truck Lines, Inc.*, 641 F. Supp. 81, 84 (S.D. Miss. 1986) (no fiduciary relationship where free to contract with others); see also *Carter Equip.* 681 F.2d at 391 (power to control is crucial issue.); *In re Will of Polk*, 497 So. 2d 815, 818 (Miss. 1986) ("[I]t is the dominant, over mastering influence over the dependent party, justifiably reposed, that gives rise to a presumption of undue influence."); *In re Will and Estate of Varvaris*, 477 So. 2d 273, 278 (Miss. 1985) (Dependency is a "crucial question.").

¹⁵⁷ 506 So. 2d 241 (Miss. 1986). In *West Point Corp.*, the court held that Miss. CODE ANN. § 75-3-606, which deals with impairment of collateral under the U.C.C., does not impose a duty upon a mortgagee to preserve real estate collateral that is not in the mortgagee's possession. *West Point Corp.*, 506 So. 2d at 244-45. The court emphasized the commercial impracticality of imposing such a requirement on the lender. *Id.* at 244.

owe a fiduciary obligation to its borrowers.¹⁵⁸ In several earlier opinions, however, the Mississippi Supreme Court opined that a trust relationship exists between a mortgagor and mortgagee.¹⁵⁹ The most important of these decisions is *First American National Bank v. Mitchell*.¹⁶⁰ In *Mitchell*, a bank officer induced the Mitchells to sell their property to a friend by wrongfully threatening to foreclose on the property.¹⁶¹ The officer knew his friend had arranged to resell the property to a second buyer for a higher price. The officer did not disclose the availability of a second buyer to the Mitchells.¹⁶² The court concluded that the officer had a duty to do so, reasoning in part that his failure to disclose the offer was an abuse of the trust relationship between mortgagor and mortgagee.¹⁶³

The court cited other reasons for its decision, specifically the officer's fraudulent conduct¹⁶⁴ and his failure to disclose facts peculiarly within his knowledge.¹⁶⁵ These facts were sufficient to impose liability on the lender without reference to fiduciary concepts, and the case is distinguishable on that basis.¹⁶⁶

¹⁵⁸ *West Point Corp.*, 506 So. 2d at 244, citing *American Bank of Commerce v. Covolo*, 88 N.M. 405, 540 P.2d 1294 (1975). In *Covolo*, the guarantors' guaranty agreements waived their right to contest the lender's release of the collateral securing a loan. *Covolo*, 540 P.2d at 1296-97. The lender effectively released the collateral by failing to perfect its security interest before the borrower filed bankruptcy. *Id.* at 1296. The guarantors argued that since the lender was a fiduciary it could release the collateral only in a commercially reasonable manner. *Id.* at 1297. In rejecting the guarantors' argument, the court remarked: "No authority is cited to support the remarkable proposition that a bank owes fiduciary duties to its debtors and obligors. Notwithstanding the growth of consumerism, this nirvana is yet to be reached." *Id.* at 1296.

¹⁵⁹ This principle was initially articulated by the court in two 1940 decisions, *Federal Land Bank v. Collum*, 201 Miss. 266, 276, 28 So. 2d 126, 127 (1946) and *Meyers v. American Oil Co.*, 192 Miss. 180, 187, 5 So. 2d 218, 220 (1941). In *Federal Land Bank*, the court stated "[T]he relationship between mortgagor and mortgagee is one of trust and is such that neither shall so conduct himself in regard to the mortgage or the mortgaged property as to prejudice the substantial rights of the other." *Federal Land Bank*, 201 Miss. at 276, 28 So. 2d at 127.

¹⁶⁰ 359 So. 2d 1376 (Miss. 1978).

¹⁶¹ *Id.* at 1377-78.

¹⁶² *Id.* at 1378.

¹⁶³ *Id.* at 1380.

¹⁶⁴ *Id.* at 1378-79.

¹⁶⁵ *Id.* at 1380.

¹⁶⁶ *Id.* The court also noted that the party's relationship was adverse "so far as payment of the debt was concerned." In *American Nat'l Ins. Co. v. Murray*, 383 F.2d 81 (5th

Since lenders are liable under Mississippi law for negligent omissions,¹⁶⁷ there is no sound reason for imposing additional disclosure obligations on mortgagees.¹⁶⁸ Fiduciary obligations should be imposed only in those rare cases in which a lender so dominates the will of its customer that a confidential relationship must be presumed to exist.¹⁶⁹ The proper approach is demonstrated by the Mississippi Supreme Court's decision in *White v. Hancock Bank*.¹⁷⁰

In *White*, White sold his business to two purchasers; the purchasers paid White with a certified check drawn on a West

Cir. 1967), a case applying Mississippi law, the court refused to recognize a fiduciary obligation between a mortgagor and mortgagee after payment of the mortgage, but held:

Where the parties deal at arms-length, there is no duty of disclosure where the facts are equally within the knowledge of both parties; but if the facts are peculiarly within the knowledge of one party, there may be a duty of disclosure under particular circumstances.

Id. at 87. Relying on this rule, the court reversed the trial court's grant of summary judgment to the mortgagor. *Id.* at 87-88. The court declined to specify when a special duty of disclosure might arise. A comment to the Restatement (Second) of Torts notes:

There are situations in which the defendant not only knows that his bargaining adversary is acting under a mistake basic to the transaction, but also knows that the adversary by reason of the relation between them, the customs of the trade or other objective circumstance, is reasonably relying upon a disclosure of the unrevealed fact if it exists.

RESTATEMENT (SECOND) OF TORTS § 551 comment 1 (1977). See *Citizens State Bank v. Federal Deposit Ins. Corp.*, 639 F. Supp. 758, 763 (S.D. Okla. 1986) (finding duty to disclose even without fiduciary relationship); see also *infra* notes 400-407 and accompanying text. But see *Shell Oil Co. v. Mills Oil Co., Inc.*, 717 F.2d 208, 214 (5th Cir. 1985) (guarantor had access to financial information allegedly concealed by lender; therefore, no duty to disclose existed).

¹⁶⁷ Mississippi has recognized that lenders may be liable to their customers for negligent misrepresentations or omissions in connection with loan or deposit transactions. Because this theory first arose in cases involving inaccurate credit references, it is discussed in the section dealing with lender liability to third parties. See *infra* notes 408-429 and accompanying text.

For a discussion of potential lender liability for negligence in special contexts, see generally Ellis & Gray, *supra* note 26 (discussing negligent processing of loan applications) and Malloy, *Lender Liability for Negligent Real Estate Appraisals*, 1984 U. ILL. L. REV. 53 (1984).

¹⁶⁸ With respect to the Mississippi decisions suggesting a trust relationship between mortgagor and mortgagee, C.J.S. notes: "While it has been stated broadly that the relationship between mortgagor and mortgagee is one of trust, technically it is not of a fiduciary character and contracts between the two are regarded and treated as any other contract would be." 59 C.J.S. *Mortgages* § 294, at 367 (1949).

¹⁶⁹ See *supra* note 156.

¹⁷⁰ 477 So. 2d 265 (Miss. 1985).

Indies Bank.¹⁷¹ The bank immediately credited White's account for the amount of the check¹⁷² and loaned White the money he needed to pay a debt he owed.¹⁷³ Subsequently, the check was dishonored by the foreign bank.¹⁷⁴

White sued the bank alleging breach of fiduciary duty and negligence.¹⁷⁵ In rejecting White's claims, the court observed there was no evidence that the bank agreed to represent White or to look out for his interests. Accordingly, the court concluded the bank officer's casual remark about the check did not make the officer and the bank "financial good samaritans" who assumed an obligation to verify the check before White accepted it from the purchasers.¹⁷⁶

C. *The Farah Torts — Fraud, Duress and Interference*

The phrase "Farah Torts" is convenient shorthand for the theories of fraud, duress and interference, all of which a borrower successfully asserted in *State National Bank v. Farah Manufacturing Co.*¹⁷⁷ *Farah*, a Texas appellate court case, has become a landmark decision in the area of lender liability.

The key actors in *Farah* were three bank lenders, Farah Manufacturing Co. (FMC) and William F. Farah (Farah). Mr. Farah was the controlling shareholder of FMC and its former chief executive officer (CEO). After FMC experienced several years of financial losses,¹⁷⁸ the FMC board of directors forced Farah to resign as CEO. When FMC's losses continued, Farah asked the board to re-elect him CEO and to elect two new directors.¹⁷⁹ However, a management change clause in FMC's loan agreement permitted the declaration of a default "for any reason" if any two of the lenders deemed that a change in the CEO

¹⁷¹ *Id.* at 267.

¹⁷² *Id.* at 268.

¹⁷³ *Id.* at 267-68.

¹⁷⁴ *Id.* at 268. Some discussion as to the validity of the check apparently had taken place between White and a bank officer. *Id.* at 267. According to the evidence, the officer volunteered that the check "looked all right to him." *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* at 271.

¹⁷⁷ 678 S.W.2d 661 (Tex. Ct. App. 1984).

¹⁷⁸ *Id.* at 667, 670.

¹⁷⁹ *Id.* at 670.

position adversely affected their interest.¹⁸⁰

The FMC board requested that the lenders approve Farah's return.¹⁸¹ Upon considering this request, the lenders decided either not to declare a default or in fact remained undecided as to the appropriate action to be taken.¹⁸² Neither of these positions was disclosed to FMC.¹⁸³ Instead, the lenders acted to prevent Farah's election by falsely representing they had decided to declare a default if Farah was elected. Their attorney wrote the FMC board that Farah's election was unacceptable and that the lenders would not grant FMC a waiver of default;¹⁸⁴ their attorney also told Farah and another director that the lenders would bankrupt and padlock FMC if Farah became CEO.¹⁸⁵

Due to these threats, Farah abandoned his efforts to elect new board members and to become CEO.¹⁸⁶ The CEO post and two of three new board positions were filled by persons affiliated with the lenders.¹⁸⁷ When FMC's finances continued to degenerate, the board retained a management consultant, recommended by the lenders, who eventually became CEO.¹⁸⁸ While CEO, this consultant sold some of FMC's assets to its competitors in order to make early loan payments to the lenders.¹⁸⁹

Thereafter, Farah initiated a proxy fight to regain control of

¹⁸⁰ *Id.* at 667. The clause allowed a declaration of default for "[a]ny change in the office of President and Chief Executive Officer of Farah [Manufacturing Company, Inc.] or any other change in the executive management of Farah [Manufacturing Company, Inc.] which any two banks shall consider for any reason whatsoever, to be adverse to the interests of the Banks." *Id.* After Farah was forced to resign, this clause was substituted for weaker clauses in two earlier loan agreements. *Id.* at 670.

¹⁸¹ *Id.*

¹⁸² *Id.* at 680. The lenders held a series of meetings. There was conflicting evidence about what the lenders decided to do. *Id.* at 670-73.

¹⁸³ *Id.* at 680.

¹⁸⁴ *Id.* at 672.

¹⁸⁵ *Id.* at 673-74.

¹⁸⁶ *Id.* at 674-75. The court noted the evidence indicated Farah's board nominees were not elected due to the lender's objection; no provision of the loan agreement pertained to changes in the board. *Id.* at 675.

¹⁸⁷ *Id.* at 676. The new C.E.O. was a director of one of the banks. *Id.* at 670. One of the new directors was a former employee of one of the lenders; additionally, the lender promised to indemnify the director from any liability arising out of his board service. *Id.* at 676. Another new director also served on one of the lender's boards. *Id.*

¹⁸⁸ *Id.* at 677.

¹⁸⁹ *Id.* at 678.

FMC.¹⁹⁰ Not surprisingly, the lenders financed a lawsuit to block Farah's return.¹⁹¹ However, when Farah prevailed in the proxy battle, the lenders decided not to declare a default if FMC would agree to restructure the loan.¹⁹² In due course, Farah restored FMC's economic health.¹⁹³ Upon repayment of the loan, FMC sued the lenders for fraud, duress and tortious interference with its management.¹⁹⁴ A modified verdict for over 18.6 million dollars was affirmed by the appellate court.¹⁹⁵

The preceding facts set the stage for an analysis of the *Farah* Torts.

1. Fraud

Fraud occurs when a speaker knowingly or recklessly makes a false representation for the purpose of inducing the listener to act or refrain from acting in reliance upon the representation.¹⁹⁶ Ordinarily, the representation must be an unequivocal statement of past or present fact.¹⁹⁷ However, the key is the speaker's intentions, not the form of the statement. Accordingly, a representation capable of two interpretations, one false and one true, is fraudulent if made with the intention that the listener accept the false rendition.¹⁹⁸ Similarly, a representation of future inten-

¹⁹⁰ *Id.* at 679.

¹⁹¹ *Id.* More specifically, the lenders financed a suit to remove Farah as the trustee of a trust controlling a significant block of FMC shares. *Id.*

¹⁹² *Id.* at 680.

¹⁹³ *Id.*

¹⁹⁴ *Id.* at 667.

¹⁹⁵ *Id.* at 699.

¹⁹⁶ RESTATEMENT (SECOND) OF TORTS § 525 (1977). In *McMahon v. McMahon*, 247 Miss. 822, 157 So. 2d 494 (1963), the Mississippi Supreme Court outlined the elements of proof required to establish fraud:

To establish fraud, there must be a representation of the falsity thereof, the materiality of the false representations, the speaker's intent that it be acted on by the other in the anticipated manner, the hearers ignorance of its falsity, his reliance on its truth, his right to rely thereon, and his consequent and proximate injury.

McMahon, 247 Miss. at 836, 157 So. 2d at 501; accord, *Grenada Ready-Mix Concrete, Inc. v. Watkins*, 453 F. Supp. 1298, 1309 (N.D. Miss. 1978)(citing same factors).

¹⁹⁷ See *Gardner v. Jones*, 464 So. 2d 1144, 1149 (Miss. 1985)(representations were vague); *McArthur v. Fillingame*, 184 Miss. 869, 876, 186 So. 828, 829 (Miss. 1939)(ordinary representation "must relate to past or presently existing facts").

¹⁹⁸ RESTATEMENT (SECOND) OF TORTS § 527 (1977) states:

tion, such as a promise, is fraudulent if the intention is purposefully misstated.¹⁹⁹

These rules were applied by the court in *Farah*.²⁰⁰ The lenders argued that fraud cannot arise from a warning of an intention to enforce legal rights.²⁰¹ The court disagreed, reasoning that the lenders' letter of warning and their statements about bankrupting and padlocking FMC were fraudulent because they created "a false impression regarding the lenders' decision (or lack of decision) to declare a default."²⁰²

Borrowers have successfully asserted claims of promissory fraud against lenders in other cases as well. In *Sterling v. Chemical Bank*,²⁰³ the court held that a group of guarantors stated a claim for fraud where they alleged they were induced to resign from their corporate positions by fraudulent assurances that the corporation's outstanding loans would not be called.²⁰⁴ In *Sanchez Corea v. Bank of America*,²⁰⁵ the court upheld a verdict for fraud against a lender who falsely promised to advance further financing if additional security for a line of credit was provided by the borrower.²⁰⁶ In *Crystal Springs Trout Co. v. First State Bank*,²⁰⁷ the court upheld a fraud verdict because the

A representation that the maker knows to be capable of two interpretations, one of which he knows to be false and the other true is fraudulent if it is made: (a) with the intention that it be understood in the sense in which it is false, or (b) without any belief or expectation as to how it would be understood, or (c) with reckless indifference as to how it would be understood.

Id.

¹⁹⁹ See, e.g., *Phillips v. Chevron U.S.A., Inc.*, 792 F.2d 521, 526 (5th Cir. 1986)(making promise with no intention of performing constitutes fraud); *Walker v. U-Haul Co.*, 730 F.2d 1068, 1070 (5th Cir. 1984)(same); see also *infra* notes 387-409 and accompanying text. But see *In re Posey*, 57 Bankr. 858 (Bankr. N.D. Miss. 1985)(no fraud by lender because alleged misrepresentation promissory in nature).

²⁰⁰ *Farah Mfg. Co.*, 678 S.W.2d at 680-82 (citing RESTATEMENT (SECOND) OF TORTS § 527 (1977) and other authorities).

²⁰¹ *Id.* at 681.

²⁰² *Id.* at 682.

²⁰³ 382 F. Supp. 1146 (S.D. N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975)(*overruled on other grounds*, *Campos v. Lefevre*, 825 F.2d 671 (2d Cir. 1987)).

²⁰⁴ *Id.* at 1153.

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

²⁰⁶ *Id.*, 701 P.2d at 830, 839, 215 Cal. Rptr. at 683, 692.

²⁰⁷ 732 P.2d 819 (Mont. 1987), *aff'd in part, rev'd in part on rehearing*, 736 P.2d 95 (Mont. 1987).

lender falsely represented that it could secure another lender's participation in a loan package which otherwise would have exceeded the lender's lending limit.²⁰⁸

Borrowers are not always successful, however. For instance, a finding of promissory fraud was overturned in *Centerre Bank*.²⁰⁹ The court concluded that the Browns had not reasonably relied upon the loan officer's representations that the corporate loan would be extended, since they knew the loan officer lacked the authority to make them.²¹⁰

Mississippi borrowers have successfully pursued fraud claims against lenders. Some of the leading cases involve a lender's failure to disclose material information to its borrower.²¹¹ Mississippi also recognizes that fraud can arise from a false promise or statement of intention.²¹² For instance, in *Home Security Corp. v. Gentry*,²¹³ the court held that a lender had fraudulently induced a borrower to execute an incomplete mortgage by promising to insert a description of only one of thirty-five acres owned by the borrower. The circumstances indicated that the lender made its promise with no intention of complying. Accordingly, the court found that fraud had been committed by the lender's insertion of a description covering the entire acreage.²¹⁴

No Mississippi decision directly addresses the type of fraudulent conduct alleged in *Farah*. On the reported facts, it is difficult to quarrel with the court's finding of fraud. The precedential value of *Farah* should not be overstated, however. The lenders' threats were a bluff. Bluffs are frequently made in com-

²⁰⁸ *Id.* at 826. At the time the representation was made, the lender had not even asked the second lender if it wanted to participate in the loan. *Id.*

²⁰⁹ See *Centerre Bank*, 705 S.W.2d at 64 (discussion of the *Centerre Bank* facts).

²¹⁰ *Id.* at 50.

²¹¹ See *supra* notes 161-166 and accompanying text (discussion of cases dealing with lender's failure to disclose material information).

²¹² *E.g.*, *Phillips v. Chevron U.S.A., Inc.*, 792 F.2d 521, 526 (5th Cir. 1986) (making promise with intention not to perform is fraudulent under Mississippi law); *Walker v. U-Haul Co. of Miss.*, 730 F.2d 1068, 1070 (5th Cir. 1984) (same); *McArthur v. Fillingame*, 184 Miss. 869, 876, 186 So. 828, 829 (1939) (same).

²¹³ 235 So. 2d 249 (Miss. 1970).

²¹⁴ *Id.* at 251. *But see* *Ricks v. Bank of Dixie*, 352 So. 2d 798, 801 (1977) (where no showing of inability to read note, claim alleging plaintiff had been tricked into signing not allowed).

mercial and legal negotiations. No fraud occurs because all the participants know or should know that declarations of position are not necessarily final. In *Farah*, the lenders deliberately misstated their position and intentions under circumstances in which FMC was fully justified in accepting the lenders' statements at face value. Absent those special circumstances, a different verdict might have been appropriate.

2. Duress

Duress and undue influence are parallel but distinct concepts.²¹⁵ Both theories are based upon the principle that a contract procured by unconscionable means should not be enforced.²¹⁶ Neither theory ordinarily is applicable unless the circumstances establish that the free agency of the complaining party was wrongfully destroyed.²¹⁷ Duress applies when the wrongdoer acts by force or threats; undue influence applies when the wrongdoer abuses the confidence of his victim.²¹⁸

Duress can take two forms — physical compulsion²¹⁹ or business compulsion.²²⁰ Business compulsion occurs when consent is obtained by improper threats that leave the threatened party with no reasonable alternative but to give in.²²¹ Therefore, to establish duress, the proof must show imminent financial distress plus the absence of practical alternatives.²²²

²¹⁵ D. DOBBS, *REMEDIES*, at 672 (1973).

²¹⁶ *Id.* at 656, 672-73; see *First Nat'l Bank v. Caruthers*, 443 So. 2d 861, 864 n.3 (Miss. 1983)(contracts obtained by overreaching, duress, undue influence are unenforceable).

²¹⁷ Compare *Duckworth v. Allis Chalmers Mfg. Co.*, 247 Miss. 198, 203, 150 So. 2d 163, 165 (1963)(The duress "of the dominant party must have been such as to override the volition of the victim.") with *Sanders v. Sanders*, 126 Miss. 610, 627, 89 So. 261, 264 (1921)(influence must overcome will of testator to be undue).

²¹⁸ "In fraud cases, the wrongdoer works his will with his victim by deception, and ordinarily this requires a misrepresentation of fact. In duress cases, he works his will by obtaining the confidence and trust of his victim." DOBBS, *supra* note 215, at 674.

²¹⁹ RESTATEMENT (SECOND) OF CONTRACTS § 174 (1981). See, e.g., *Johnson v. Glass*, 156 Miss 670, 671-72, 126 So. 476, 477 (1930)(plaintiff had been whipped, thrown into jail).

²²⁰ RESTATEMENT (SECOND) OF CONTRACTS § 175 (1981).

²²¹ *Id.*

²²² *Palmer Barge Line v. Southern Petroleum Trading*, 776 F.2d 502, 506 (5th Cir. 1985). See also *Grubel v. Union Mutual Life Ins. Co.*, 54 A.D. 2d 686, 387 N.Y.S. 2d 442,

No concrete standard has been formulated for determining what constitutes an improper threat or an absence of reasonable alternatives. A threat must be unlawful to be improper. Merely threatening to do that which one has a legal right to do ordinarily is not sufficient to establish duress.²²³ The application of financial pressure, without more, is not duress, even if the pressure is created by a disparity in bargaining power. Likewise, since effective redress is available through the courts, economic discomfort or strain is insufficient to establish lack of a reasonable alternative.

In *Farah*, the same facts²²⁴ which contributed to a finding of fraud resulted in a finding of duress as well. The lenders argued that duress cannot arise from warnings about the consequences of enforcing legal rights.²²⁵ The court acknowledged that the management change clause authorized the lenders to declare a default and accelerate the loan if FMC changed its CEO.²²⁶ The court concluded, however, that section 1-208 of the U.C.C. precluded evoking the management change clause unless the lenders concluded in good faith that their security was impaired. Until *Farah* was actually elected, the lenders had no basis to

443 (1976)(financial pressure insufficient even with unequal bargaining power); *DOBBS*, *supra* note 215, at 659 ("Much coercion - strong bargaining power - is permissible, expected and heartily approved in a competitive economic society.")

²²³ See *Peterson v. Merchants Truck Line, Inc.*, 448 So. 2d 288, 290-91 (Miss. 1984)(threat to turn matter over to fidelity insurance carrier not wrongful since individual had legal right to do so); *McGehee v. McGehee*, 227 Miss. 170, 183, 85 So. 2d 799, 804 (Miss. 1956)(no duress where acting within legal rights).

According to the Restatement (Second) of Contracts, a threat is improper if:

- (a) what is threatened is a crime or a tort, or the threat itself would be a crime or a tort if it resulted in obtaining property,
- (b) what is threatened is a criminal prosecution,
- (c) what is threatened is the use of civil process and the threat is made in bad faith, or
- (d) the threat is a breach of the duty of good faith and fair dealing under a contract with the recipient.

RESTATEMENT (SECOND) OF CONTRACTS § 176(1)(1981).

²²⁴ *Farah Mfg.*, 678 S.W.2d at 683. Specifically, the court considered the lenders' letter to the FMC board, its oral threats to bankrupt and padlock FMC, and the lenders' interference with the election of FMC's board. *Id.*

²²⁵ *Id.* at 684.

²²⁶ *Id.* at 686.

conclude that their prospects of payment were impaired.²²⁷ Accordingly, the court held that the lenders' threats were improper and thus constituted duress.²²⁸

The court erred. As previously discussed, section 1-208 of the U.C.C. places a good faith limitation only on a lender's right to accelerate a loan "at will" or for "insecurity." It was not intended to limit the ability of lenders and borrowers to define a particular event — such as a change in management — as an event of default which would permit acceleration.²²⁹ Absent fraud, the lenders were entitled to warn FMC of the potential consequences of Farah's election as CEO. Any other rule would impose unwarranted restrictions upon both borrowers and lenders by inhibiting lenders' freedom to respond to borrowers' requests for approval of contemplated conduct.

Mississippi courts have consistently rejected claims of duress based upon lenders' threats to enforce their rights under loan agreements. For instance, in *River Valley Co. v. Deposit Guaranty National Bank*,²³⁰ the court rejected River Valley Co.'s claim that a mortgage had been procured by duress.²³¹ When the mortgage was granted, River Valley was in default under a line of credit agreement. The lender threatened to file suit unless River Valley provided the lender with additional security and a note for the sums owed. Thereafter, when River Valley failed to pay the note, the lender foreclosed.²³² The court concluded that the lenders' threats were not duress because the lender "had a perfect legal right to pursue all legal remedies at its command to collect the debt"²³³ and because there was no

²²⁷ *Id.* at 685. The court relied on *Brown v. Avemco Inv. Corp.*, 603 F.2d 1367 (9th Cir. 1979), discussed herein, *supra* notes 52 - 53, and the RESTATEMENT (SECOND) OF CONTRACTS § 176 (1981), which states a threat is improper if it is a breach of the duty of good faith and fair dealing. *Farah Mfg.*, 678 S.W.2d at 685.

²²⁸ *Farah Mfg.*, 678 S.W.2d at 686.

²²⁹ See *supra* notes 76 - 78 and accompanying text. For a case enforcing a lender's right to declare a default under a management change clause, see *Camelot Ltd. v. Union Mutual Life Insurance Co.*, 154 Ariz. 330, 742 P.2d 832 (1987).

²³⁰ 331 F. Supp. 698 (N.D. Miss. 1971).

²³¹ *Id.* at 706-07.

²³² *Id.* at 703.

²³³ *Id.* at 706.

evidence that River Valley had lost its free will.²³⁴

Farah imposed tort liability on the lenders for duress²³⁵ even though duress is not generally recognized as a tort.²³⁶ The remedy for duress is rescission and restitution, not damages.²³⁷ Applying vague standards formulated with a restitution remedy in mind to cases in which actual and punitive damages are sought is inappropriate.²³⁸ In *Farah*, the lenders' statements and threats were fraudulent. Had there been no misrepresentation of intention, the lenders actions would have been legal, since lender approval of management changes was authorized by the loan agreement. Since a fraud remedy for damages was available, the court's finding of duress was surplusage and should not be relied upon as precedent.

²³⁴ *Id.* at 707; see also *Adams v. Mark Oil, Inc.*, 431 So. 2d 489, 490 (Miss. 1983)(quitclaim not induced by threat of prosecution for debts); *Bullock v. Green*, 224 Miss. 278, 287-88, 80 So. 2d 37, 41 (1955)(refusal to set aside deed of trust on ground procured by threat of prosecution).

²³⁵ *Farah Mfg.*, 678 S.W.2d at 683.

²³⁶ "[D]uress is not in and of itself a recognized tort." DOBBS, *supra* note 215, at 657. See also RESTATEMENT (SECOND) OF CONTRACTS, Introductory Note at 474 (1981)("Since duress and undue influence, unlike deceit, are not generally of themselves actionable torts, the victim of duress or undue influence is usually limited to avoidance and does not have an affirmative action for damages."). But see *Pecos Const. Co. v. Mortgage Inv. Co.*, 80 N.M. 68, 459 P.2d 842, 843-45 (1969)(permitting recovery of delay damages for duress).

²³⁷ See, e.g., *Patterson v. Merchants Truck Line, Inc.*, 448 So. 2d 288, 289 (Miss. 1984)(action sought rescission of conveyance of property); see also RESTATEMENT (SECOND) OF CONTRACTS, Introductory Note at 474 (1981)(avoidance, not damages, is ordinary remedy); DOBBS, *supra* note 215, at 656 (remedies are "essentially restitutionary").

²³⁸ Professor DOBBS explains that the reason damages are not permitted is that duress is conceived in vague terms of morality which, while appropriate for defensive purposes, requires a more limited remedy than damages:

Hardly any wrongdoing considered in this chapter is defined in terms that will bear the rigorous analysis of a lawyer. That being so, judges have hesitated to impose an affirmative obligation in damages . . . For the most part, the cases here have it in common that the substance behind them being so poorly defined, the remedy is a limited one.

DOBBS, *supra* note 215, at 655. The *Farah Mfg.* court cited Professor DOBBS for the proposition that "restitution (damages)" are recoverable. *Farah Mfg.*, 678 S.W.2d at 683. FMC was awarded actual losses, lost profits and the difference between the market value and the actual value of the FMC assets and equipment sold at auction. Only the latter was restitutionary in nature. See DOBBS, *supra* note 215, at 657 (victim of duress entitled to recover value of property taken through coercion when property cannot be returned).

3. Interference

Intentional interference with contracts and prospective business relations is generally recognized as a tort. To impose liability, the proof must establish that the interferer had actual knowledge of the relation interfered with and that the interference was without legal right or justifiable cause. Also, the interference must proximately cause the loss complained.²³⁹ Interference is privileged when undertaken to protect the bona fide interests of the interferer.²⁴⁰ The scope of this privilege is limited, however. The privilege is lost when the means used to interfere are tortious or otherwise wrongful.²⁴¹ The Restatement (Second) of Torts suggests that the question of privilege turns on whether the social benefits expected from permitting the interference are outweighed by the harm flowing from the interference, in other words a "balancing" of interests.²⁴² The courts are divided on whether the interferer has the burden of proving that the interference was privileged.²⁴³

The relation interfered with by the lenders' in *Farah* was FMC's right to select its own management.²⁴⁴ The court found

²³⁹ See *In re Knickerbocker*, 827 F.2d 281, 287 (8th Cir. 1987)(listing elements of intentional interference); *Edwards v. Travelers Ins. Co.*, 563 F.2d 105, 120 (6th Cir. 1977) (same); *Irby v. Citizens Nat'l Bank*, 239 Miss. 64, 67, 121 So. 2d 118, 119 (1960)(same); RESTATEMENT (SECOND) OF TORTS § 766A (1977)(interference with contract); *id.* at § 766B (interference with prospective contractual relations).

²⁴⁰ The interest can be economic, e.g., RESTATEMENT (SECOND) OF TORTS § 769 (1977) (financial interest in business induced); *id.* at § 771 (financial stake in business activities of person induced); or legal, e.g., *id.* at § 773 (assertion of bona fide claim).

²⁴¹ *Walker, Common Law Protection of Expectancies: 'Business Torts' in Mississippi*, 50 Miss. L.J. 335, 345 (1979). See also RESTATEMENT (SECOND) OF TORTS § 777 (1977) (privilege to interfere in business policy of relation in which the interferer has an economic interest if means employed are not wrongful).

²⁴² RESTATEMENT (SECOND) OF TORTS § 767 (1977). See also *Frank Coulson, Inc. v. General Motors Corp.*, 488 F.2d 202, 206 (5th Cir. 1974)("The principle issue thus becomes whether the social benefits derived in permitting acts of intervention outweigh the harm to be expected therefrom.")

²⁴³ Compare *Thompson v. Allstate Insurance Co.*, 476 F.2d 746, 748 (5th Cir. 1973)(under Alabama law, interferer must prove his actions privileged) with *Howard v. Chrysler Corp.*, 705 F.2d 1285, 1287 (10th Cir. 1983)(under Colorado law, plaintiff must establish interference not privileged).

²⁴⁴ *Farah Mfg.*, 678 S.W.2d at 690. One commentator has suggested that *Farah Mfg.* created a new tort of "interference with choice of management" distinct from the traditional tort of interference with contractual or business relations. *Sneed & Athay, supra*

that the lenders' interference resulted in the election of inexperienced directors and officers whose divided loyalty caused injury to FMC.²⁴⁵ The court brushed aside the lenders privilege defense because "their conduct failed to comport with the standards of fair play"²⁴⁶ and because the court concluded the social benefits derived from the interference were outweighed by the harm to be expected from the interference.²⁴⁷

Following *Farah's* lead, three recent federal diversity decisions have held that lenders may be liable in tort for interference with their borrowers' management: *Whitney v. Citibank*,²⁴⁸ *Melamed v. Lake County National Bank*,²⁴⁹ and *Citibank, N.A. v. Data Lease Financial Corp.*²⁵⁰

In *Whitney*, the lender induced two of three partners in a general partnership to deed partnership property to the lender in lieu of foreclosure. The third partner, Whitney, was unaware of this transaction.²⁵¹ The court found that the lender's actions were motivated by a desire to deceive the general partners and to earn a profit on the sale of the property.²⁵² Additionally, the court noted that the lender knew the third general partner was unsophisticated and that the two partners were acting for themselves in signing the deed and not for the partnership.²⁵³ On these findings, the court upheld a verdict against the lender for

note 69, at 9 n.72

²⁴⁵ *Farah Mfg.*, 678 S.W.2d at 688. The interference included (i) the lenders' prevention of Farah's election as C.E.O. and the election of his board candidates; (ii) the lenders' packing of the board with their hand-picked candidates; (iii) the lenders' participation in the selection of two new C.E.O.s; and (iv) the lenders' support of the proxy fight against Farah. *Id.*

²⁴⁶ *Id.* at 690.

²⁴⁷ *Id.* at 691.

²⁴⁸ 782 F.2d 1106 (2nd Cir. 1986).

²⁴⁹ 727 F.2d 1399 (6th Cir. 1985).

²⁵⁰ 828 F.2d 686 (11th Cir. 1987). In addition to the cases discussed in the text, see *Paradise Hotel Corp. v. Bank of Nova Scotia*, No. 87-3318 (3d Cir. March 15, 1988)(Westlaw, Dist file). The *Paradise* court held that a lender wrongfully joining in the filing of a Chapter 7 bankruptcy petition against a borrower may be liable for intentional interference with the borrower's business relations. *Paradise*, No. 87-3318 (Westlaw).

²⁵¹ *Whitney*, 782 F.2d at 1109-11. The lenders gave no consideration for the property and partnership law requirements and the partnership agreement were not followed. *Id.* at 1109.

²⁵² *Id.* at 1117.

²⁵³ *Id.* at 1116-17.

actual and punitive damages.²⁵⁴

In *Melamed*, the Sixth Circuit overturned a trial court's grant of summary judgment in favor of a lender on a bankrupt borrower's tortious interference claim. The lender required the borrower to (i) replace its accountant with one selected by the lender, (ii) submit payments to the lender for approval, (iii) cut the pay of its president, and (iv) implement a "13-point program" designed to salvage the lender's losses.²⁵⁵ On these facts, the court rejected the lender's contention that its actions were privileged and concluded that the issue of interference should have been submitted to the jury.²⁵⁶

Citibank, N.A. also overturned a summary judgment granted the lender.²⁵⁷ The borrower, Data Lease Financial Corp. (Data Lease), pledged its stock in Miami National Bank (MNB) to secure a multimillion dollar loan. The pledge agreement authorized Citibank to vote Data Lease's shares in MNB in the event of a default. When Data Lease defaulted, Citibank used its votes to elect a new board for MNB.²⁵⁸ Data Lease contended that the new board's interference in Data Lease's rights in the stock caused a dramatic decline in MNB's stock and thus amounted to conversion.²⁵⁹ The Eleventh Circuit held summary judgment was inappropriate because the control exercised by Citibank over the directors indicated that the directors might have been acting as Citibank's agents.²⁶⁰

Other courts have held that a lender's assertion of its rights under the loan agreement is privileged, even though the exercise of those rights interferes with the borrower's business. Illustrative cases are *Flintridge Station Associates v. American Fletcher*²⁶¹ and *Del State Bank v. Salmon*.²⁶²

²⁵⁴ *Id.* at 1117-19.

²⁵⁵ *Melamed*, 727 F.2d at 1403-04.

²⁵⁶ *Id.*, at 1404.

²⁵⁷ *Citibank*, 828 F.2d at 690-94.

²⁵⁸ *Id.* at 689.

²⁵⁹ *Id.* at 690-91. Data Lease did not base its claim on interference per se, but styled its claim as one for conversion and negligent bailment. *Id.*

²⁶⁰ *Id.* at 692. For a discussion of the degree of control required to prove agency, see *infra* notes 320-336 and accompanying text. A lender was held liable on interference with a specific contract relation in *In re Knickerbocker*, 827 F.2d 281, 287-88 (8th Cir. 1987).

²⁶¹ 761 F.2d 434 (7th Cir. 1985).

²⁶² 548 P.2d 1024 (Okla. 1976).

In *Flintridge*, a limited partnership developing a real estate project requested an increase in its construction loan. Since the partnership was in default, the lender conditioned its consent on the partnership disassociating itself from the developer and one of the borrower's general partners who was financially interested in the developer.²⁶³ The court held the lender's conduct was privileged because "[a] lender has a legitimate concern in the management of its borrowers, and consequently in the security of its investments."²⁶⁴

In *Del State Bank*, the bank sued to collect on a loan Salmon had used to purchase stock in Amerand, Inc., of which Salmon was president. After this loan was made, the bank used its economic influence and power to squeeze Salmon out of the corporation.²⁶⁵ Applying the balancing test advocated by the Restatement (Second) of Torts,²⁶⁶ the court held that the bank's actions were privileged because it had a legitimate economic interest in Amerand, Inc. and because the means it employed to protect its interest were not improper. The court emphasized that the bank's purpose in using its economic power was to further its own financial position, not to wrongfully harm Salmon.²⁶⁷

An action for tortious interference with present or prospective contracts is viable under Mississippi law.²⁶⁸ Mississippi courts also recognize that a lender is privileged to interfere with its borrower's business if such interference is intended to protect

²⁶³ *Flintridge*, 761 F.2d at 441.

²⁶⁴ *Id.* at 442.

²⁶⁵ *Del State Bank*, 548 P.2d at 1025. The other shareholders accomplished the squeeze-out by exchanging their Amerand shares for shares in another entity, which thereafter became the principal shareholder and manager of Amerand. Salmon sought but was refused permission to transfer his stock. *Id.* at 1027.

²⁶⁶ *Id.* at 1027-28.

²⁶⁷ *Id.* at 1027. Although the bank used its economic power to influence Amerand's board to end Salmon's employment, its primary objective was to better its financial position, not to wrongfully harm Salmon. *Id.*

²⁶⁸ See, e.g., *Mid-Continent Telephone Corp. v. Home Telephone Co.*, 319 F. Supp 1176, 1199-1200 (N.D. Miss. 1970)(imposing liability for interference with contract); see generally, Walker, *supra* note 241, at 335-72 (thorough discussion of Mississippi case law); Franck, *The Tort of Wrongful Interference with Contracts: A Conflict of Values* 38 Miss. L. Inst. 131 (1983)(same).

the lender's legitimate interests. For instance, in *Ross v. Deposit Guaranty National Bank*,²⁶⁹ a lender's assignment of its security interest in stock pledged to secure a note was deemed privileged interference in the pledgor's ownership rights.²⁷⁰

No published Mississippi decision has considered the imposition of liability on a lender for interference in its borrower's management relations. Given lenders' legitimate interests in the operations of its borrowers, Mississippi courts should think twice before following *Farah's* lead. A lender's interference should be deemed privileged provided the lender's objective is the enforcement of the rights granted by the loan agreement. Lenders should be entitled to pursue these rights as vigorously as any other person in privity with the borrower.

In rare cases, a lender's exercise of its rights may result in the assumption of additional duties and obligations under principles of corporate law. A lender that becomes a de facto director of a borrower arguably should be subject to the duties of a director,²⁷¹ including the duties of care²⁷² and loyalty.²⁷³ Mere

²⁶⁹ 400 F. Supp. 45, 152 (S.D. Miss. 1974); see *Martin v. Texaco, Inc.*, 304 F. Supp. 498, 502 (S.D. Miss. 1969)("[I]nterference is not wrongful and actionable if undertaken by someone in the exercise of a legitimate interest or right, which constitutes 'privileged interference.'"). There are conflicting federal decisions on whether the interferer has the burden of establishing his actions were privileged under Mississippi law. *Compare Carter Equip. Co. v. John-Deere Indus. Equip. Co.*, 681 F.2d 386, 396 (5th Cir. 1982)(burden on plaintiff) with *Mid-Continent Tel.*, 319 F. Supp. at 1200 (N.D. Miss. 1970)(burden on interferer). The former case is consistent with *Irby v. Citizens Nat'l Bank*, 239 Miss. 64, 121 So. 2d 118 (1960) in which the Mississippi Supreme Court held the plaintiff must demonstrate the defendants' interference was "without right or justifiable cause." *Id.* at 67; 121 So. 2d at 119. In *Irby*, the court dismissed a borrower counterclaim alleging that a lender had interfered with certain of his contracts in Louisiana by notifying a Louisiana lender the borrower was in poor financial condition. The borrower contended that as a result of this notification the Louisiana lender cut-off the borrower's working capital which, in turn, caused the abandonment of construction contracts in Louisiana. The court affirmed the trial court's dismissal of the claim because the complaint did not allege the Mississippi lender's actions were without right or justifiable cause or that the Louisiana lender would not have otherwise called its loans. *Id.* at 68; 121 So. 2d at 119.

²⁷⁰ *Ross*, 400 F.Supp. at 152.

²⁷¹ See A. HENN & J. ALEXANDER, *LAW OF CORPORATIONS* § 206, at 562 (3d ed. 1983)("Anyone assuming to act as a director is subject to the duties of a director.").

²⁷² Directors and officers of a corporation owe a duty of due care to the corporation in managing its affairs. *Id.* § 234 at 621. The courts are divided on whether the standard for liability is ordinary negligence or gross negligence. Holmes, *The Revised Model Business Corporation Act and Corporate Law Reform in Mississippi: Part One*, 56 Miss. L.J.

errors in business judgment ordinarily do not breach these duties.²⁷⁴ The court in *Farah* ignored this rule and held the lenders liable for FMC's business losses, even though there was no direct evidence that the officers or directors foisted on FMC by the lenders had breached their duties.

D. *Prima Facie Tort*

When the facts will not support a case for fraud or interference, some borrowers have attempted to impose liability upon lenders under the prima facie tort theory,²⁷⁵ also referred to as "abuse of rights."²⁷⁶ Under this theory, liability may be imposed for an intentional lawful act that was meant to cause injury to

165, 191 (1986). The Mississippi Business Corporation Act provides that a director must discharge his duties in good faith with the care of an ordinarily prudent person in like circumstances and position and in a manner the director reasonably believes is in the corporation's interest. MISS. CODE ANN. § 79-4-8.30 (Supp. 1987).

²⁷⁵ Directors and officers of a corporation owe a fiduciary duty of loyalty to the corporation in managing its affairs. HENN & ALEXANDER, *supra* note 271, § 236, at 628. For a discussion of this duty and liability for its breach under Mississippi law, see Hodge & Perry, *The Model Business Corporation Act: Does the Mississippi Version Lime the Bushes?*, 46 Miss. L.J. 371, 386-90 (1975); Holmes, *supra* note 272, at 202-12; Kecker & Hunt, *supra* note 94, at 28-38; Comment, *Transactions Between a Corporation and Its Directors: Where Does Mississippi Stand?*, 52 Miss. L.J. 877, 899-95 (1982).

²⁷⁴ Under the business judgment rule, a director is not liable for an erroneous decision so long as there is a reasonable basis for the decision and the actor acts in good faith uninfluenced by any loyalty other than the director's honest belief in what is in the corporation's best interest. HENN & ALEXANDER, *supra* note 271, § 242 at 661; Holmes, *supra* note 272, at 191.

The authors recognize the admittedly complex issues involved in determining whether officers and directors have fulfilled their corporate duties. See Holmes, *supra* note 272, at 195 n.123 (citing numerous scholarly articles dealing with the standard of conduct for directors). Lenders controlling their borrowers, however, should not be held to a greater standard of care than the borrowers' owners, directors and officers.

Authors' supplemental note: *Farah* also ignored the rule that the tort of interference protects contracting parties from interference by a third party not in privity with them. This rule was applied to overturn a jury verdict in favor of a guarantor for interference in *Kruse v. Bank of America*, to be reported in 201 Cal. App. 3d 354, 248 Cal. Rptr. 217 (1988), a case decided after this article was submitted to the printer. A claim for tortious interference ordinarily cannot be brought by one party to a contract against the other because a contract remedy is available. See *Ryan v. Brookly Eye and Ear Hospital*, 46 A.D.2d 87, 360 N.Y.S.2d 912, 916 (1974).

²⁷⁵ See *infra* notes 284-295 and accompanying text.

²⁷⁶ See *Lambert v. Maryland Cas. Co.*, 403 So. 2d 739, 755-57 (La. App. 1981)(rejecting abuse of rights claim against surety financing its contractor principal).

another person's property or trade without just cause.²⁷⁷ Most courts reject this doctrine because it conflicts with the traditional rule that an "improper motive does not operate to make an otherwise lawful act unlawful."²⁷⁸

The jurisdictions that recognize the prima facie tort theory have formulated several restrictions on its application. When the complained of conduct is cognizable under an existing tort theory, a prima facie tort action may not be brought.²⁷⁹ The rationale is that the prima facie tort applies only when the underlying conduct is lawful in itself; when the conduct is tortious, a traditional remedy is available. In addition, "disinterested malevolence" must be shown.²⁸⁰ When conduct is motivated by legitimate as well as improper purposes, the tort is inapplicable.²⁸¹

The lender liability decisions suggest that the lender's interest in collection of its loan may create an insurmountable barrier to liability under the prima facie tort theory. A trilogy of Missouri appellate cases is demonstrative. In *Centerre Bank*,²⁸² the

²⁷⁷ *Centerre Bank*, 705 S.W.2d at 53-54. RESTATEMENT (SECOND) OF TORTS § 870 (1977) states: "One who intentionally causes injury to another is subject to liability to the other for that injury, if his conduct is generally culpable and not justifiable under the circumstances. This liability may be imposed although the actor's conduct does not come within a traditional category of tort liability." *Id.* The tort has been recognized in the United States since at least 1904. See *Aikens v. Wisconsin*, 195 U.S. 194, 204 (1904) ("[P]rima facie, the intentional infliction of temporal damage is a cause of action, which, as a matter of substantive law, whatever may be the form of the pleading, requires a justification if the defendant is to escape.") For an in-depth discussion of the prima facie tort theory, see Note, *The Prima Facie Tort Doctrine in Missouri: Commission of a Lawful Act With Intent to Injure May Result in Liability*, 50 Mo. L. Rev. 128, 129-36 (1981). Most of the cases construing the prima facie tort doctrine have arisen in Missouri and New York. See Annotation, 16 A.L.R. 3d 1191, 1201-31 (1967 & supp. 1987)(listing cases).

²⁷⁸ *Perdue v. J.C. Penney Co.*, 470 F. Supp. 1234, 1239 (S.D. N.Y. 1979)(applying Texas law); see also, *Fowler v. Williamson*, 39 N.C. App. 715, 251 S.E.2d 889, 892 (1979) ("The exercise of a legal right cannot constitute a tort even if there is wrongful intent."); *Teas v. Republic Nat'l Bank*, 460 S.W.2d 233, 242 (Tex. Civ. App. 1970) ("Malicious motives make a bad case worse, but it cannot make that wrong, which, in its own essence, is lawful.")

²⁷⁹ See *Ruza v. Ruza*, 286 A.D. 767, 146 N.Y.S. 2d 808, 810-11 (1985)(rejecting prima facie tort claim on grounds that specific torts were alleged); *Advance Music Corp. v. American Tobacco Co.*, 296 N.Y. 79, 84, 70 N.E.2d 401, 403 (1946)(where specific acts are asserted, doctrine of prima facie tort may not be invoked).

²⁸⁰ *American Bank & Trust Co. v. Federal Reserve Bank*, 256 U.S. 350, 358 (1921).

²⁸¹ See *infra* notes 294-295 and accompanying text.

²⁸² *Centerre Bank*, 705 S.W.2d at 42. See *supra* notes 60-64 and accompanying text

court refused to impose liability under the prima facie tort theory on the basis that the lender clearly had a valid business reason for calling the note.²⁸³ In *Rigby Corp. v. Boatman's Bank & Trust Co.*,²⁸⁴ the court affirmed a grant of summary judgment to the lender on the prima facie tort theory. The court concluded that the bank's interest in collecting a note was a sufficient interest in and of itself to protect the lender, even if the lender's conduct amounted to breach of contract.²⁸⁵ Finally, in *Shaunnessy v. Mark Twain State Bank*,²⁸⁶ the court affirmed a trial court's directed verdict on a borrower's prima facie tort claim because there was no evidence that the lender's conduct had a malicious purpose. The court concluded that the mere intent to perform the act that injured the plaintiff was insufficient to impose liability under the prima facie tort theory.²⁸⁷ Actual "malice," "spite" or "ill will" must be shown.²⁸⁸

Although Mississippi has not recognized the prima facie tort by name, Mississippi arguably recognizes the substance of the theory.²⁸⁹ For example, in *Memphis Steam Laundry-Cleaners, Inc. v. Lindsey*,²⁹⁰ the Mississippi Supreme Court held that where the purpose of a businesses' price cutting is to destroy its rival rather than compete in the market place, tort relief may be had.²⁹¹ Similarly, in *Wesley v. Native Lumber Co.*,²⁹² the court suggested that an otherwise lawful act becomes unlawful if its purpose is to maliciously injure the business of another person.²⁹³

No reported Mississippi case discusses the applicability of

for a discussion of the facts in *Centerre Bank*.

²⁸³ *Centerre Bank*, 705 S.W.2d at 55.

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

²⁸⁵ *Id.* at 545.

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

²⁸⁷ *Id.* at 948-49.

²⁸⁸ *Id.* at 949 (quoting *Dowd v. General Motors Acceptance Corp.*, 685 S.W.2d 868, 874 (Mo. Ct. App. 1984)).

²⁸⁹ See *Walker*, *supra* note 241, at 335, 339-42 (discussing cases).

²⁹⁰ 192 Miss. 224, 5 So. 2d 227 (1941).

²⁹¹ *Id.* at 239, 5 So. 2d at 232.

²⁹² 97 Miss. 814, 53 So. 346 (1910).

²⁹³ *Id.* at 820, 53 So. at 346-47. The defendant intentionally threatened to discharge employees who traded with plaintiff. *Id.*

the prima facie tort theory to lenders.²⁹⁴ Because lenders always have a legitimate economic interest in the collection of their loans, it is difficult to envision a scenario under which a borrower could recover on a prima facie tort theory of liability. The prima facie tort theory and the theory of good faith and fair dealing suffer from the same fundamental flaw — vagueness.²⁹⁵

II. THIRD PARTY THEORIES

Although it was conceivable that a lender might be liable to its borrowers with whom there was a direct contractual relationship, lenders certainly could not foresee that liability to unknown third parties might ever be imposed. In actuality, however, the lender liability cases have taken a turn in that direction.

Third parties in lender liability actions assert the very same theories as borrowers, only from a slightly different perspective. As a result, much of what has been said in Part I of this article regarding borrower theories necessarily applies here as well. The following discussion addresses the various theories in light of the third party approach. The theories are segregated into three groups, based upon factors mutually determinative for liability within each group: (1) the "control" theories, which include instrumentality, alter ego and agency cases; (2) the fiduciary relationship and equitable subordination cases; and (3) the "tort" theories, including fraud and intentional misrepresentation, negligent misrepresentation, and tortious interference with contract.

²⁹⁴ The Mississippi Supreme Court came close, however, in *National Mort. Co. v. Williams*, 357 So. 2d 934 (Miss. 1978). The court affirmed an award of actual and punitive damages for the lenders wrongful foreclosure of a mortgage. The court cited with approval a section of *Corpus Juris Secundum* stating that a mortgagor is entitled to recover damages when a "foreclosure is attempted solely from a malicious desire to injure the mortgagor." *Id.* at 935 (quoting 59 C.J.S. *Mortgages* § 491 at 774 (1949)). The reported facts and the court's discussion, however, indicated that liability was imposed for the mortgagee's malicious breach of its obligations under the mortgage. *Id.* at 935-37. The prima facie tort theory presumes recovery is not available on any other legal theory. See *supra* note 280 and accompanying text.

²⁹⁵ See *supra* notes 89-90 and accompanying text.

A. *The Control Theories — Instrumentality, Alter-ego and Agency*

A common allegation in lender liability cases is that the lender assumed control over the debtor to such an extent that the lender should be liable for the actions and obligations of the debtor. Regardless of whether the cause of action is asserted under a theory of "instrumentality", "alter-ego", or "agency", the determining issue is still the same: did the lender control the borrower?²⁹⁶ If so, the lender may be liable. The key lies in how

²⁹⁶ One author views the various theories as lying on a spectrum of creditor conduct based on control: the shared control and possibly shared profit cases, such as partnership and joint venture cases, lie at one end of the spectrum; the agency cases rest in the middle; and finally the cases involving domination of the borrower, such as instrumentality and alter ego cases, occupy the opposite end of the spectrum. Schechter, *supra* note 11, at 931-32.

Third parties might also attempt to impose liability against a lender under a joint venture theory. Specifically, third parties could allege that a bank which finances operations or loans money to a business occupies a position as a joint venturer in that business and should, therefore, be liable for the debts and obligations of the business. In Mississippi, however, such an assertion will be difficult to sustain. Under Mississippi law, two elements are essential to find a joint venture relationship: (1) an agreement, either express or implied from the conduct of the parties, and (2) the parties must share the profits of the activity. *Hernando Bank v. Bryant Elec. Co.*, 357 F. Supp. 575, 584 (N.D. Miss. 1973). The mere fact the bank receives interest on funds loaned to the business should not constitute a "sharing of profits" so as to impose liability. *See Edwards v. Northwestern Bank*, 39 N.C. App. 261, 250 S.E.2d 651, 661 (1979), *aff'd on appeal after remand*, 53 N.C. App. 492, 281 S.E.2d 86 (1981) (court ruled no joint venture existed because of lack of sharing of control and profits; no profit sharing existed because lender entitled to receive only principal amount plus normal rate of interest). One author argues the presence or absence of profit sharing should not be dispositive of the issue of liability:

It is true that a controlling creditor not sharing in the profits generally receives no compensation beyond that set out in the initial agreement. However, to view the contractually established compensation as both a ceiling and a floor is to ignore the realities of the typical control situation. As the cases discussed thus far show, control rarely arises at the time the debtor firm is established. Typically, once the debtor encounters financial difficulties, its existing major secured creditor decides to salvage as much as possible rather than to foreclose immediately on inadequate and depreciated collateral. At the time the decision to assume control is made, the creditor is almost always badly undersecured. The compensation for control, indeed the motivation for control, is the prospect that the salvage operation will increase the value of the collateral before the debtor collapses. The benefit sought by the creditor — the net enhancement of the collateral or paydown of the debt during the period of control — often is far more substantial than profit sharing would be, especially when the

much "control" the court requires before imposing liability. In the landmark decision, *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,²⁹⁷ the United States Court of Appeals for the Fifth Circuit held virtual total control was required.

Krivo addressed the liability of a lender under the instrumentality theory to creditors of its borrower. In *Krivo*, ten creditors sued the primary creditor, National Distillers, after the debtor corporation, Brad's Machine Products, Inc. (Brad's), became insolvent.²⁹⁸ Bridgeport Brass Company (Bridgeport), a division of National Distillers, was the major supplier of brass for Brad's.²⁹⁹ When Brad's unpaid open account reached approximately one million dollars, Brad's and Bridgeport entered into a "financing and loan agreement."³⁰⁰ As a result, Bridgeport agreed to continue to supply Brad's with brass, provided shipments were paid for within a specified time.³⁰¹ Notwithstanding the new payment arrangement, Brad's financial condition worsened and the Government threatened to cancel its fuse contract with Brad's. Brad's and National Distillers adopted a plan to financially salvage Brad's,³⁰² which later became the foundation

debtor is deeply insolvent and unprofitable. Thus, the shibboleth of profit sharing ought not be determinative of liability.

Id.

²⁹⁷ 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974).

²⁹⁸ *Id.* at 1101.

²⁹⁹ *Id.* at 1107. In 1966, John C. Bradford, the owner of Brad's, decided to enter into the munitions industry and employed Arnold Seitman to assist in entering the Government contracting market. Seitman successfully obtained a \$2.7 million contract for Brad's to produce M-125 fuses. Bradford invented a new method for producing the fuses, primarily composed of brass, and thereby "revolutionized" the industry. *Id.* As a result, the M-125 fuses became Brad's major product, constituting ninety percent of Brad's gross sales. *Id.* By 1969, Bridgeport was supplying \$400,000-\$500,000 of brass rods each month to Brad's. *Id.*

³⁰⁰ *Id.* at 1108. Under the agreement, Bridgeport accepted a promissory note, personally guaranteed by Bradford and his wife. Additionally, certain real property owned by a subsidiary of Brad's was mortgaged to Bridgeport as collateral for the loan. *Id.* at 1107. The note required monthly payments of \$40,000, plus interest, and a final balloon payment in March 1970. *Id.* at 1107-08. However, the note could be extended in the event Brad's successfully contracted with the Government prior to April 1, 1970 to supply additional fuses. *Id.* at 1108.

³⁰¹ *Id.* Brad's was required to pay for shipments within 15-16 days, with a 10 day grace period. *Id.*

³⁰² *Id.*

for a suit against National Distillers under the instrumentality theory.³⁰³ Pursuant to the plan, National Distillers was to perform five primary functions: (i) provide internal financial management assistance to Brad's, (ii) loan Brad's an additional \$600,000 cash, (iii) extend the time in which Brad's must repay an additional \$630,000 account receivable, (iv) assist in a liquidation of unprofitable holdings, and (v) persuade the Government not to cancel its fuse contract with Brad's.³⁰⁴ Despite these efforts, Brad's financial situation became hopeless and Brad's ceased operations.³⁰⁵ Thereafter, ten unpaid creditors sued National Distillers for payment of money owed by Brad's, contending that National Distillers should be liable for Brad's debts under the instrumentality theory.³⁰⁶ On appeal, the Fifth Circuit affirmed the district court's directed verdict in favor of National Distillers, holding the evidence insufficient to establish the required control for imposition of the instrumentality theory.³⁰⁷

The importance of the *Krivo* decision rests with the rigorous standards the Fifth Circuit laid down before liability to a third party attaches under the instrumentality theory.³⁰⁸ In strong

³⁰³ *Id.* at 1109.

³⁰⁴ *Id.* at 1108. In accordance with this plan, National Distillers accepted a note for the \$600,000 cash loaned and the \$630,000 account receivable owed. As collateral, National Distillers took a security interest in Brad's plant, furniture and equipment. *Id.* Additionally, Brad's assigned to National Distillers certain stock and leases for liquidation, the proceeds of which were to be given to Brad's for working capital. *Id.* National Distillers also assigned two of its employees to Brad's: an internal auditor to supervise finances and to establish controls over cash and investments, and another employee to assist in disposal of assets. *Id.*

³⁰⁵ *Id.* at 1109.

³⁰⁶ *Id.* at 1101. The instrumentality rule provides that "when one corporation controls and dominates another corporation to the extent that the second corporation becomes the 'mere instrumentality' of the first, the dominant corporation becomes liable for those debts of the subservient corporation attributable to an abuse of that control." *Id.*

³⁰⁷ *Id.*

³⁰⁸ The court analyzed the facts in light of two essential elements for application of the instrumentality theory: (1) control, and (2) damage to the plaintiff through misuse of that control. *Id.* at 1103. In examining control, the court analogized to situations wherein one corporation has an ownership interest in another corporation. *Id.* at 1104. The court noted that evidence of ownership does not "per se" determine the issue of control. *Id.* Likewise, the court noted that lack of ownership will not "per se" abrogate the issue of control where "actual and total control has been otherwise established." *Id.* *But cf.* Lundgren, *supra* note 11, at 532 ("[T]he court may have been overly influenced by the

language, the Fifth Circuit ruled that something much greater than a mere creditor-debtor relationship must be proven to establish the requisite control for liability under the instrumentality theory:

The general rule is that the mere loan of money by one corporation to another does not automatically make the lender liable for the acts and omissions of the borrower. [citations omitted]. The logic of this rule is apparent, for otherwise no lender would be willing to extend credit. The risks and liabilities would simply be too great. Nevertheless, lenders are not automatically exempt from liability under the "instrumentality" rule. If a lender becomes so involved with its debtor that it is in fact actively managing the debtor's affairs, then the quantum of control necessary to support liability under the "instrumentality" theory may be achieved.

An examination of "instrumentality" cases involving creditor-debtor relationships demonstrates that courts require a strong showing that the creditor assumed *actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control, as used in the "instrumentality" doctrine, by the creditor corporation.*³⁰⁹

The court concluded that the control necessary to hold a creditor liable under the instrumentality theory is a "total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation."³¹⁰

instrumentality cases involving debts between parent and subsidiary corporations.")

³⁰⁹ *Krivo*, 483 F.2d at 1104-05 (emphasis added).

³¹⁰ *Id.* at 1106. In *FMC Finance Corp. v. Murphree*, 632 F.2d 413 (5th Cir. 1980), the guarantor of payments under a lease agreement asserted that the corporate entity should be disregarded and responsibility imposed upon the subsidiary for the acts of the parent corporation. *Id.* at 420. Citing *Krivo*, the *Murphree* court noted that a control amounting to total domination must exist to impose liability upon a parent corporation for the acts of a subsidiary. *Id.* at 422. However, where the plaintiff seeks to impose liability upon a subsidiary for acts of the parent, the court ruled that total domination is not required. Instead, only a "control relationship" between the two entities is necessary. *Id.* The court held that an "implied misrepresentation in the extension of credit" would be sufficient to impose liability upon the subsidiary, stating:

A creditor has the duty to first ascertain the creditworthiness of the corpora-

In applying the aforementioned standards to the facts of the case, the court concluded that National Distillers had exercised no greater control than any creditor would typically do in a creditor-debtor relationship.³¹¹ At most, National Distillers had acted in a reasonable manner to safeguard its interests and had not assumed the "actual, participatory, total control" necessary to impose liability under the instrumentality doctrine.³¹² In so ruling, the Fifth Circuit correctly determined that lenders have legitimate interests that should be protected. Before such rights can be defeated, a high degree of control, wrongfully used, must be proven.

The *Krivo* ruling was expressly relied upon in *Irwin & Leighton, Inc. v. W.M. Anderson Co.*,³¹³ a recent decision ad-

tion he voluntarily deals with, and assumes the risk of possible default by that corporation when he extends credit . . . When the shareholder or affiliate, however, engages in conduct likely to create in the creditor the reasonable expectation that he is extending credit to an economic entity larger than the corporation he actually contracted with, and the creditor reasonably relies to his detriment on his reasonable belief concerning who or what he was dealing with, then the corporate veil can be pierced.

Id. at 423 (citations omitted). As a result, any lender affiliated with a corporation should insure that persons dealing with the corporation realize that two distinct entities are involved. *See, e.g.*, *Divco-Wayne Sales Fin. Corp. v. Martin Vehicle Sales, Inc.*, 45 Ill. App. 2d 192, 195 N.E.2d 287, 289-90 (1963)(parent manufactured vehicles; subsidiary financed sales of parent's vehicles).

³¹¹ *Krivo*, 483 F.2d at 1110. Although stock ownership is not conclusive of control, the court considered whether National Distillers held an ownership interest in Brad's. The plaintiff creditors alleged ownership. However, the evidence showed only that National Distillers may have *intended* at one point in time to accept an assignment of stock, but that such assignment had never been consummated. *Id.* at 1109. The court found no substance in plaintiffs' allegations that National Distillers threatened to fire and replace officers and employees of Brad's, finding instead that National Distiller's control was limited to its ability to monetarily control Brad's. *Id.* at 1110. The court also rejected plaintiffs' contentions that National Distillers had assumed direct control over Brad's day-to-day operations. *Id.* The court ruled that employees placed on the job site by National Distillers served narrow purposes. For example, the internal auditor's function was to control purchases and disbursements. *Id.* at 1111. As such, the internal auditor implemented certain controls. Although approval of purchases was required, such approval was not required in all instances and it was never denied where the purchase served a legitimate business purpose. *Id.* Other National Distiller's employees assigned to Brad's were determined only to be engaged in offering advice, assisting where needed in production, and otherwise fulfilling tasks (such as disposal of assets) to which Brad's had freely agreed. *Id.* at 1112.

³¹² *Id.* at 1110.

³¹³ 532 A.2d 983 (Del. Ch. 1987).

addressing the liability of a surety, active in the financing and management of a troubled debtor, to a third party. The surety, Fidelity and Deposit Company of Maryland (Fidelity), had not bonded the particular job in question. However, the plaintiff nevertheless asserted, among other allegations, that the surety had controlled the contractor to such a degree that principles of alter ego should apply and the surety be deemed liable for the contractor's breach of contract.³¹⁴

When the contractor, Anderson, became financially distressed, Fidelity, with complete and voluntary consent of Anderson, engaged CMA to review Anderson's financial affairs and to make recommendations. CMA determined that Fidelity would suffer a loss of approximately \$17,000,000 on bonded projects if Anderson shut down. In lieu thereof, Fidelity retained CMA to monitor Anderson's financial affairs and assist in the day to day financial operations.³¹⁵

After Anderson's unsuccessful attempt to obtain bank financing, Fidelity extended a loan to Anderson, secured by a joint control and trust agreement. The terms of the agreement required receipts on bonded and unbonded projects to be segregated. Receipts on bonded projects could be spent only on bonded projects, and, although Anderson retained power to select the particular bills to be paid, such payments were subject to final approval by Fidelity. Additionally, Fidelity obtained a security interest in Anderson's properties.³¹⁶

The court refused to impose liability upon Fidelity, stating that a creditor cannot be held liable for the debtor's obligations "[w]here, as here, the third party creditor became involved with

³¹⁴ *Id.* at 984. The evidence established that the troubled debtor, W.M. Anderson Co. (Anderson), had contracted with Irwin & Leighton, Inc. (Irwin) to perform as mechanical subcontractor on a government project. Due to substantial financial difficulties, Anderson defaulted on the job. Irwin sued Anderson and Fidelity and Deposit Company of Maryland ("Fidelity") for the damages it incurred as a result of the default. *Id.* In addition to the alter ego theory, the plaintiff asserted that Fidelity had wrongfully interfered with Anderson's contractual obligations and had violated a particular Delaware statute. *Id.*

³¹⁵ *Id.* at 985. CMA was actively involved in developing an accounting system for Anderson, meeting with Anderson personnel to review and approve payments on bonded jobs, etc. CMA, however, never became involved in unbonded projects. *Id.* at 990.

³¹⁶ *Id.*

the corporation as the result of an arms-length extension of credit or other arms-lengths transactions and thereafter comes to exercise control over the debtor by reason of a default or threatened default."³¹⁷ The court ruled that Anderson had maintained its separate corporate identity and that any power Fidelity possessed over Anderson resulted solely from the agreement

³¹⁷ *Id.* at 989, citing *Krivo*. The court also expressly relied upon the decision in *McFadden, Inc. v. Baltimore Contractors, Inc.*, 609 F. Supp. 1102 (E.D.Pa. 1985). In *McFadden*, a subcontractor sought payment from USF&G, a bonding company, for construction work performed pursuant to an agreement with Baltimore Contractors, Inc. (Baltimore). *McFadden*, 609 F. Supp. at 1103. Although USF&G had not bonded the construction project in question, it had bonded several other major construction projects by Baltimore. *Id.* Baltimore became financially distressed and USF&G realized it could lose up to \$50,000,000 if it assumed completion of the bonded projects for Baltimore. *Id.* In lieu thereof, USF&G entered into an agreement with Baltimore by which USF&G loaned Baltimore \$20,000,000 for funding of its operations. *Id.* Certain conditions, discussed hereinafter, were included in the agreement to protect USF&G's position as a major creditor of Baltimore. *Id.* In its suit against USF&G, it was this agreement which the subcontractor used to assert that USF&G had assumed control of Baltimore and should therefore be liable for Baltimore's debts under the instrumentality theory. *Id.* at 1104.

The court ruled the question whether Baltimore had become the instrumentality of USF&G was one of law for the court. *Id.* Citing *Krivo*, the *McFadden* court determined that USF&G could not be liable under the instrumentality theory, as it had not taken "absolute and total control of Baltimore." *Id.* at 1105. The court rejected the subcontractor's contentions that the conditions of the loan agreement evidenced a domination by USF&G over Baltimore. For example, the court found that the provisions requiring assignment of Baltimore's future payments to USF&G were merely imposed to insure payment on the loan. *Id.* at 1106. The requirement that USF&G approve certain payments by Baltimore was merely a control measure to insure that loaned funds were properly used for bonded projects. *Id.* Similarly, the agreement to furnish USF&G with a monthly accounting of unbonded projects and the requirement that Baltimore obtain USF&G's written consent before entering into any new construction contracts were justified measures to monitor Baltimore's activities and to minimize USF&G's risks. *Id.* at 1106-07. Even though Baltimore granted an irrevocable power of attorney to USF&G which allowed USF&G to complete bonded projects, the court found that such power in no way authorized USF&G to control unbonded projects or projects bonded by other surety companies. *Id.* at 1107. *But see* Schroeder, *supra* note 69, at 1208 ("While [a power of attorney] is a fine idea in theory, it is simply one more factor which can lead to a claim of domination by the principal, or to a claim of alter-ego liability by third parties."). Finally, the court rejected the contention that USF&G's refusal to bond new contracts of Baltimore until a new chief executive officer was hired constituted domination. *McFadden*, 609 F. Supp. at 1108. In light of Baltimore's financial distress, the court considered it reasonable to require confidence in the chief executive officer who would be running the company. *Id.* Considering all the evidence, the court concluded that USF&G had not exercised "total and actual control" over Baltimore and therefore could not be liable under the instrumentality theory. *Id.*

which had been negotiated at arms length.³¹⁸ The court concluded that the plaintiff had chosen to contract with Anderson without requiring a bond and should therefore be the party to bear the loss.³¹⁹

³¹⁸ *Irwin & Leighton*, 532 A.2d at 990.

³¹⁹ *Id.* The court reasoned that the fact that "Anderson Co.'s creditors came to exercise influence or even dominating practical power over Anderson Co., can, in these circumstances, provide to Irwin no substitute for the surety bond it did not obtain." *Id.* In contrast to *Irwin* and *McFadden*, a surety successfully asserted the instrumentality theory as a defense to liability under a bond in *Neese v. Fireman's Fund Ins. Co.*, 53 Tenn. App. 710, 386 S.W.2d 918 (1964). In *Neese*, the trustee in bankruptcy for First Trust Company sued Fireman's Fund Insurance Company (Fireman's), the surety on a bond for Real Estate Management, Inc. (REMCO). *Id.* at 918. The suit arose after Fireman's refused to pay a claim filed by First Trust on the grounds that REMCO and First Trust were so closely connected that the two should be treated as one legal entity. *Id.* at 919.

The evidence of control in *Neese* was overwhelming. One shareholder and his immediate family owned more than seventy percent of the outstanding stock in both REMCO and First Trust. *Id.* Additionally, the primary shareholder, Scott Brown, held offices as president, chairman and treasurer for both corporations. Brown regulated the financial affairs so tightly that he approved all payments in excess of \$100. *Id.* Ten of REMCO's directors also served as the directors for First Trust. With only one exception, both corporations had the same elected officers, appointed officers, and executive committees. *Id.* at 919-20. The two corporations were jointly operated, and even occupied the same office space. "The two companies had the same address and the same phone number; there was overlapping of personnel; office materials and supplies were stored together; hiring for both companies was usually done by the same person; until the end of 1961, all employees of both companies were paid on checks of REMCO; after that, on checks of First Trust Company." *Id.* at 920. Finally, numerous financial transactions were executed between the two corporations. Any debt owed from one company to the other was recorded in an "intercompany note account" and evidenced by a written document, but no attempt was ever made to collect such notes. *Id.* The court concluded that the aforementioned evidence proved a domination "so complete that neither corporation had any mind, will or existence of its own." *Id.* at 922. The court considered the proof in light of the discussion of the instrumentality doctrine as set forth in 1 FLETCHER CYC. CORP. § 43 (perm. ed. 1963), which states:

"A very numerous and growing class of cases wherein the corporate entity is disregarded is that wherein it is so organized and controlled, and its affairs are so conducted, as to make it merely an instrumentality, agency, conduit, or adjunct of another corporation. The control necessary to invoke what is sometimes called the 'instrumentality rule' is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal. * * * One corporation may be disregarded where the two are identical or indistinguishable in fact. Unless it is a mere instrumentality or agency or adjunct in that sense, or as a sham or is used in fraud, by the dominant corporation, it will not be disregarded; and it will not be disregarded unjustly."

Neese, 386 S.W.2d at 921. *But see* *Continental Bankers Life Ins. Co. v. Bank of Alamo*,

Third parties have enjoyed more success in imposing liability on lenders by use of the agency theory. Unlike the court in *Krivo*, the Supreme Court of Minnesota in *A. Gay Jenson Farms Co. v. Cargill, Inc.*³²⁰ imposed liability against a lender under an agency theory.³²¹ In *Jenson*, eighty-six farmers sued the lender, Cargill, Inc., for a \$2 million indebtedness³²² owed by Warren Grain & Seed Co.³²³ to the farmers. The court affirmed the jury verdict that Cargill had become the principal and War-

578 S.W.2d 625, 631, 632 (Tenn. 1979) ("We do not agree that the *Neese* court intended the quote from 1 FLETCHER CYC. CORP. § 43 (perm. ed 1963) to define the elements of proofs required to invoke the instrumentality rule in Tennessee"; court set forth three elements of instrumentality doctrine: (1) total domination, (2) use of control to commit wrongful act, and (3) proximate cause of injury). The court ruled that the two corporations were "identical or indistinguishable in fact," and that First Trust could not recover on the bond. *Neese*, 386 S.W.2d at 922; see also Tennessee Consol. Coal Co. v. Home Ice & Coal Co., 25 Tenn. App. 316, 156 S.W.2d 454, 456 (1941)(claim of insurance company against Home Ice & Coal Co. subordinated to claims of other creditors on basis that Home Ice was so dominated as to be agent or instrumentality of insurance company; evidence showed that insurance company made loan on real estate and assumed control over property and its operations after abandonment of debtor.) But see *Continental Bankers*, 578 S.W.2d at 627 (bank asserted instrumentality theory as defense in suit by subsidiary corporation for recovery of certificate of deposit applied against loan balance due to bank from parent corporation; court ruled that bank had failed, as matter of law, to meet burden of establishing one-corporation defense so as to justify disregard of corporate entities).

³²⁰ 309 N.W.2d 285 (Minn. 1981).

³²¹ *Id.* at 291. The RESTATEMENT (SECOND) OF AGENCY § 1(1)(1958) defines agency as "the fiduciary relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." Authors Ebke & Griffin have said that the *Jenson* decision implicitly recognizes a fiduciary duty by a controlling creditor to a debtor, the benefits of which extend to any person harmed by misuse of that relationship. Ebke and Griffin, *supra* note 9, at 794. However, Ebke and Griffin comment that, in view of "the inherent propensity of agricultural states to protect the interests of farmers", the *Jenson* decision may be limited to its facts and its effect not so encompassing. *Id.* See generally Kunkel, *The Fox Takes Over the Chicken House: Creditor Interference With Farm Management*, 60 N.D.L. REV. 445 (1984).

³²² *A. Gay Jenson Farms*, 309 N.W.2d at 289-90.

³²³ *Id.* at 288. Warren Grain & Seed Co. (Warren) operated a grain elevator and engaged in the business of grain storage for local farmers, as well as cash purchases of grain for resale. *Id.* Cargill, Inc. (Cargill) loaned money to Warren for working capital. In exchange, Warren appointed Cargill as its grain agent for transactions with a certain credit corporation and also granted a first right of refusal to Cargill for the purchase of grain. *Id.* Although the amount of financing initially was limited to \$175,000, Cargill consistently increased its financing until Warren's indebtedness to Cargill at the time it ceased operations reached \$3.6 million. *Id.* at 288-89.

ren its agent,³²⁴ citing nine factors supporting such finding,³²⁵ including such apparently innocuous acts as Warren's use of pre-printed forms bearing Cargill's name; Cargill's recommendations to Warren by phone and by letter, etc.

The *Jenson* court paid lip service to the traditional lender/debtor relationship, implying that the result would have been different if the lender had been a bank.³²⁶ The court considered

³²⁴ *Id.* at 291. The RESTATEMENT (SECOND) OF AGENCY § 14 O (1958) provides: "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." *Id.* This section takes on greater meaning when read in connection with its Official Comment, which states:

a. A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as a principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.

Where there is an assignment for the benefit of creditors, the latter may become the principals of the assignee if they exercise control over transactions entered into by him on their behalf.

Id. at comment a.

The *Jenson* court expressly relied upon the language of § 14 O and its corresponding comment in imposing liability. *A. Gay Jenson Farms*, 309 N.W.2d at 291.

³²⁵ *A. Gay Jenson Farms Co.*, 309 N.W. 2d at 291. The court listed the following factors as evidence of the agency relationship:

- (1) Cargill's constant recommendations to Warren by telephone;
- (2) Cargill's right of first refusal on grain;
- (3) Warren's inability to enter into mortgages, to purchase stock or to pay dividends without Cargill's approval;
- (4) Cargill's right of entry onto Warren's premises to carry on periodic checks and audits;
- (5) Cargill's correspondence and criticism regarding Warren's finances, officers' salaries and inventory;
- (6) Cargill's determination that Warren needed "strong paternal guidance";
- (7) Provision of drafts and forms to Warren upon which Cargill's name was imprinted;
- (8) Financing of all Warren's purchases of grain and operating expenses; and
- (9) Cargill's power to discontinue the financing of Warren's operations.

Id.

³²⁶ *Id.* at 292. The court expressly stated that, as to lenders, "[t]he decision in this case should give no cause for concern." *Id.* Several organizations, including the Northwestern National Bank of Minneapolis, submitted amicus curiae briefs to the court. *Id.*

Cargill's business to be "markedly different from an ordinary bank financing, since Cargill was an active participant in Warren's operations rather than simply a financier."³²⁷

The *Jenson* court placed too much emphasis upon the classification of the lender. All lenders have justifiable interests which should be protected. The *Jenson* court disturbed the rights of lenders by imposing liability under a lesser standard than that set forth in *Krivo*. In essence, the *Jenson* court allowed the plaintiffs to circumvent the rigorous, yet proper, standards of *Krivo* by phrasing the cause of action in terms of "agency" rather than "instrumentality." Despite the theory asserted, control is the key issue. The standards applied and the results reached should be identical, irrespective of whether the theory is instrumentality, agency, or alter ego.

The Texas Court of Civil Appeals refused to allow the agency theory to be used to impose liability upon a lender in *Lane v. Dickinson State Bank*.³²⁸ Allegedly, plaintiff Lane was employed by Maritime Group Companies, Inc., (Maritime) pursuant to a written five year employment agreement. After only eighteen months of employment, Lane was discharged. Lane sued Maritime for wrongful breach of contract.³²⁹ Additionally, Lane sued Dickinson State Bank and its president under the theory of corporate alter ego.³³⁰ Lane alleged that the bank and its president had dominated Maritime, running Maritime as if it were their own company, and ultimately resulting in Maritime's destruction.³³¹ In support of his allegations, Lane asserted that the bank had loaned \$60,000 to Maritime, falsely declaring that the maturity date was five to seven years when, in fact, the note became due after only one year.³³² Furthermore, Lane alleged

at 290. These amicus curiae briefs asserted that, if the jury decision were affirmed, banks would refuse to make future loans to grain elevators. *Id.* at 292.

³²⁷ *Id.* at 292-93. The court concluded that "[a]lthough considerable interest was paid by Warren on the loan, the reason for Cargill's financing of Warren was not to make money as a lender but, rather, to establish a source of market grain for its business."

³²⁸ 605 S.W.2d 650 (Tex.Civ.App. 1980).

³²⁹ *Id.* at 651.

³³⁰ *Id.* at 652.

³³¹ *Id.* at 651, 652, and 653 n.1.

³³² *Id.* at 651. As a result, the loan was successively renewed in a series of ninety-day notes. *Id.*

that the president had assigned his personal accountant to Maritime and required the accountant's signature on all corporate checks.³³³ In addition to applying corporate funds without Maritime's consent to reduce the indebtedness to the bank, Lane also contended that the president arranged additional funding for Maritime from a company the president controlled.³³⁴ As a matter of law, the court held that Lane failed to assert a claim upon which relief could be granted.³³⁵ The court ruled that the alter ego theory is inapplicable in a situation "where the individuals are not alleged to be shareholders, incorporators, directors, or officers of the target corporation."³³⁶

In 1975, the Mississippi Supreme Court adopted the doctrine of piercing the corporate veil and the instrumentality rule.³³⁷ In *North American Plastics, Inc. v. Inland Shoe Manufacturing Co.*,³³⁸ a Mississippi federal court reviewed Mississippi law and articulated a set of ten factors to be considered in determining if the instrumentality rule applies:

- (1) The parent corporation owns all or a majority of the capital stock of the subsidiary.
- (2) The parent and subsidiary corporations have common directors or officers.
- (3) The parent corporation finances the subsidiary.
- (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation.
- (5) The subsidiary has grossly inadequate capital.
- (6) The parent corporation pays the salaries or

³³³ *Id.*

³³⁴ *Id.* at 651-52.

³³⁵ *Id.* at 653.

³³⁶ *Id.* Despite its ruling, the court acknowledged that a cause of action may lie against a third party who influences a corporation and causes harm to an individual. However, the court considered Lane's pleadings, and concluded that he had not alleged any fraudulent acts against him by the bank, nor that the bank had caused his discharge, nor that the bank's "allegedly fraudulent activity caused the financial condition of Maritime to deteriorate to the point that his discharge became necessary." *Id.* The court emphasized Lane's pleading that the fraud committed by the bank and its president had caused the destruction of Maritime, "not that it caused financial ruin." *Id.* at 653 n.1. The court reasoned that, rather than causing any harm to the corporation, Maritime may have succeeded in staying in business as long as it did only as a result of the bank's continued cooperation and financing. *Id.* at 653.

³³⁷ *Johnson & Higgins of Miss., Inc. v. Commissioner of Ins.*, 321 So. 2d 281, 285 (Miss. 1975).

³³⁸ 592 F. Supp. 875 (N.D. Miss. 1984).

expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation and in the statements of its officers, "the subsidiary" is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.³³⁹

These factors are consistent with the *Krivo* requirements and are equally applicable in lender liability actions based on theories of agency or alter ego.

With respect to claims founded on agency principles, Mississippi follows the strictures of *Krivo* and *North American Plastics, Inc.* The United States District Court for the Northern District of Mississippi laid the proper foundation for lender liability in Mississippi when it refused to impose a principal/agent relationship on the financier in *XYOQUIP, Inc. v. Mims*.³⁴⁰ The plaintiff, XYOQUIP, Inc., (XYOQUIP) was engaged in the business of financing the lease of Freezie Slush drink machines. Under the leasing arrangement, Freezie Corporation, through its employee, Frady, would submit a signed lease, a letter of acceptance acknowledging receipt of the machines, and certain financial data regarding the lessee to XYOQUIP. Additionally, Freezie Corporation would prepare a bill of sale for the machines to XYOQUIP. If the documents were approved, XYOQUIP would sign the lease, thereby closing the transaction.³⁴¹

The defendants entered into a lease agreement for twenty machines, which was approved for financing and paid by XYOQUIP. Despite the signed letter acknowledging receipt of twenty machines in acceptable condition, defendants later notified XYOQUIP that only four machines had been delivered, all of which were defective. Defendants refused to make any lease payments,

³³⁹ *Id.* at 879.

³⁴⁰ 413 F. Supp. 962 (N.D. Miss. 1976).

³⁴¹ *Id.* at 963-64.

and XYOQUIP brought suit to recover.³⁴²

Defendants denied liability for the lease payments, asserting that Frady had negotiated the transaction as the agent — either actual, apparent or implied — of the financier, XYOQUIP. The court, however, rejected the contention that an agency relationship existed,³⁴³ quoting three elements required before an agency relationship can be found: “a manifestation of the principal, by either his words or conduct or both, that the agent shall act for him, the agent’s acceptance of the undertaking, and, most critically, the understanding of the parties that the principal is to be in control of the undertaking.”³⁴⁴

The court found that the aforementioned elements had not been satisfied to impose an agency relationship. The court noted that Frady was an employee of Freezie Corporation and never held himself out as acting on behalf of XYOQUIP. In fact, except to the extent that XYOQUIP’s name appeared on the forms used, the defendants had no knowledge of plaintiff’s existence until subsequent to the closing of the transaction. The court correctly ruled that use of plaintiff’s forms, alone, was insufficient to impose an agency relationship since “[s]uch a practice is common in the commercial community.”³⁴⁵ The court determined that, at most, XYOQUIP financed the sale of machines by Freezie Corporation and supplied Freezie with the forms to accomplish such transactions.³⁴⁶

Likewise, the court rejected plaintiff’s contentions that an implied agency existed, holding that plaintiff’s conduct had not evidenced an intention to create such a relationship,³⁴⁷ neither did the court find any apparent authority to act, stating that apparent authority cannot exist where there is no actual, express, or implied agency relationship.³⁴⁸

³⁴² *Id.* at 965.

³⁴³ *Id.* at 966.

³⁴⁴ *Id.* at 965, citing 2A C.J.S. Agency § 36.

³⁴⁵ *Id.*

³⁴⁶ *Id.* at 965-66.

³⁴⁷ *Id.* at 966.

³⁴⁸ *Id.* The court restated the law regarding apparent authority:

A principal, having clothed his agent with the semblance of authority, will not be permitted, after others have been led to act in reliance of the appearances thus produced, to deny, to the prejudice of such others, what he has thereto-

Thus, the law in Mississippi is established that overwhelming control must be proven before liability can be imposed against a lender. This remains true whether the cause of action is founded on the instrumentality doctrine, alter ego, or agency theories.

B. *Fiduciary Theories and Equitable Subordination*

The decisions in the agency cases discussed previously are influenced in part by the concept of a fiduciary relationship. The Restatement (Second) of Agency section 14 defines an agency as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." When a fiduciary relationship exists, a lender may owe duties to other creditors of the borrower, as well as to the borrower itself, and may be liable for any breaches of such duties.³⁴⁹

Mississippi has not yet imposed a fiduciary obligation upon lenders to third parties. However, under general corporate principles, fiduciary obligations have been imposed upon directors and shareholders of corporations. In *Love Manufacturing Co. v. Queen City Manufacturing Co.*,³⁵⁰ the court ruled that directors of an insolvent corporation cannot prefer themselves by using corporate assets to pay debts owed to them. The court reasoned that "[t]o permit it would be to allow those intrusted with the governing power of a corporation to prefer themselves by their own determination and action, —a proposition monstrous in the extreme, shocking to the moral sense, and wholly indefensible, as it seems to us. . . ."³⁵¹

Since general corporate principles are extensively relied

fore tacitly affirmed as to the agent's powers. There are three essential elements to apparent authority: (1) *Acts or conduct of the principal*; (2) reliance thereon by a third person; and (3) a change of position by the third person to his detriment. All must concur to create such authority.

Id. (emphasis added).

³⁴⁹ The RESTATEMENT (SECOND) OF TORTS § 874 (1979) states: "One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation." *Id.*

³⁵⁰ 74 Miss. 290, 20 So. 146 (1896)(action to set aside assignment for benefit of creditors under which certain directors and shareholders became preferred creditors).

³⁵¹ *Id.* at 147; see also *Keker & Hunt, supra* note 94, at 28-29 (discussion of *Love*).

upon in analyzing the lender liability theories, it can be inferred that, under the *Love* ruling, a lender could be classed as a fiduciary. However, the strict requirements of *Krivo* should apply before a lender is determined to be a fiduciary. Lenders have an independent, bargained-for interest to protect and should be allowed to assert all rights granted by loan agreements to protect such interests.

Accordingly, the Mississippi Supreme Court has indicated that a high standard must be met before a lender will be classed as a fiduciary to third parties. In *Champion International Corp. v. First National Bank*,³⁵² a seller of goods brought suit against a bank for fraudulent and negligent misrepresentation regarding the credit worthiness of its customer. Additionally, the seller sought to impose a form of fiduciary obligation upon the bank by imposition of a constructive trust for the benefit of the seller upon funds in the bank.³⁵³ Although the court's language expressly referred to a "constructive trust", the same principles should apply in imposing any form of fiduciary duty. Specifically, the court ruled:

A constructive trust is one that arises by operation of law against one who, by fraud, actual or constructive, by duress or abuse by any form of unconscionable conduct, artifice, concealment, or questionable means, or who in any way against equity and good conscience, either has obtained or holds the legal right to property which he ought not, in equity and good conscience, to hold and enjoy.³⁵⁴

The court properly held that mere negligence would not be sufficient to impose a constructive trust.³⁵⁵

³⁵² 642 F. Supp. 237 (S.D. Miss. 1986).

³⁵³ *Id.* at 239.

³⁵⁴ *Id.* at 243.

³⁵⁵ *Id.*; *cf.* *Central Bank v. Butler*, 517 So. 2d 507, 512 (Miss. 1987)(court upheld award of actual and punitive damages where bank offset funds known to be held in trust for third party against individual indebtedness of depositor); *Vickers v. First Miss. Nat'l Bank*, 458 So. 2d 1055, 1062 (Miss. 1984)(court reversed summary judgment in favor of defendant bank, holding that bank owed direct contractual obligation, as opposed to fiduciary obligation, to shareholder individually); *Armour-Cudahy Packing Co. v. First Nat'l Bank*, 69 Miss. 700, 11 So. 28, 29 (1892)(where bank had notice that funds in customer's account were held for benefit of third party, bank's subsequent application of such funds to pay customer's overdrafts were at peril of bank and jury question existed

The Mississippi Supreme Court expressly refused to recognize any fiduciary obligations between competing banks. In *Citizens National Bank v. First National Bank*,³⁵⁶ Citizens National Bank (CNB) asserted the theory of fiduciary duty against First National Bank (FNB) in an effort to hold FNB liable for losses suffered by CNB as the result of a check kiting scheme by a mutual customer. CNB alleged that FNB became aware of the check kiting scheme in March or April, 1974. Thereafter, without informing CNB of the customer's scheme, FNB commenced to return all checks presented for payment which had been drawn on FNB and deposited with CNB. At the same time, however, FNB continued to accept checks drawn on CNB as deposits, which were then presented to CNB and paid.³⁵⁷ CNB alleged that FNB accumulated such funds with the purpose of applying such funds to debts owed FNB. CNB further alleged that such actions were wrongful in that the funds were owned by CNB and that FNB had obtained such funds by "false pretense, conversion, or misappropriation."³⁵⁸

The Mississippi Supreme Court refused to impose a fiduciary duty on FNB. The court noted that the two banks were competitors. The court found no facts to support a confidential or fiduciary relationship between the banks, nor any requirement in the bank industry that one bank notify another bank of such unlawful customer practice. As such, the court held that FNB was under no duty to inform CNB of the customer's scheme and, additionally, that FNB had a legal right to refuse payment of checks drawn on it while continuing to present CNB checks for payment.³⁵⁹

Another form of fiduciary theory, generally applied in the

whether bank had misappropriated funds).

³⁵⁶ 347 So. 2d 964 (Miss. 1977).

³⁵⁷ *Id.* at 966.

³⁵⁸ *Id.*

³⁵⁹ *Id.* at 967. The court likewise rejected CNB's allegations that FNB had acted fraudulently. Since there was no duty to disclose the scheme, FNB's actions could not constitute a fraud. The court found no representations by FNB to indicate that CNB had been wrongfully induced to pay checks drawn on it. *Id.* at 969. The court also discussed ownership of the funds and concluded that once CNB paid the checks FNB became the owner of the funds and therefore could not be liable for conversion or misappropriation. *Id.* at 968.

bankruptcy context, is that of equitable subordination of the lender's claims.³⁶⁰ In 1939, the United States Supreme Court handed down two leading decisions addressing equitable subordination: *Taylor v. Standard Gas & Electric Co.*³⁶¹ and *Pepper v. Litton*.³⁶²

Taylor sets forth what has come to be commonly known as the "Deep Rock Doctrine." Petitioners, the trustee in bankruptcy and certain preferred stockholders of Deep Rock Oil Corporation (Deep Rock), protested a claim filed by Standard Gas & Electric Co. (Standard) as creditor.³⁶³ The petitioners asserted that the transactions leading up to the debt owed to Standard were fraudulent and that Deep Rock had become the agent or instrumentality of Standard, thereby precluding Standard from asserting a claim as a creditor.³⁶⁴

The evidence established that Standard completely controlled Deep Rock, not only through majority ownership of the common stock but also through common officers and directors. The Court found that through this control Standard had the opportunity to mismanage Deep Rock, and did so.³⁶⁵ The Court

³⁶⁰ See, e.g., *In re Bowman Hardware & Elec. Co.*, 67 F.2d 792, 794 (7th Cir. 1933)(lender's claim subordinated to that of another creditor for failure to disclose debt upon inquiry by creditor); *In re American Lumber Co.*, 7 Bankr. 519, 529 (Bankr. D. Minn. 1979), *aff'd*, 5 Bankr. 470, 478 (D. Minn. 1980)(bank's claim subordinated to that of general creditors on ground debtor's grant of security interest in inventory and equipment to bank constituted fraudulent conveyance). For an excellent comparison of the agency theory with the fiduciary theory, see Schechter, *supra* note 11, at 937-39 (proposes that standard for liability under fiduciary theory should be stricter since creditor may be liable in tort, as well as be required to "undo its former dealings", whereas alter ego theory imposes liability only for debtor's obligations).

³⁶¹ 306 U.S. 307 (1939).

³⁶² 308 U.S. 295 (1939).

³⁶³ *Taylor*, 306 U.S. at 311.

³⁶⁴ *Id.* at 312. The court commented that the "instrumentality rule" is not technically a rule, but rather an equitable principle which allows disregard of the corporate entity where to do otherwise would work a fraud or injustice. The court noted that the principle is properly applied "to give minority stockholders redress against wrongful injury to their interests by a majority stockholder." *Id.* at 322. The court held that § 77B of the Bankruptcy Act protects shareholders in the same manner. *Id.*

³⁶⁵ *Id.* at 310. For example, dividends were paid at times when cash was unavailable, thereby requiring Deep Rock to borrow large sums of money from Standard. *Id.* at 317. The court alluded to the possibility that such dividends were paid to keep the voting power of the preferred shareholders from arising, since the preferred shareholders had no voting rights unless dividends were in arrears six months. *Id.* at 320 n.4. When Deep

concluded that the preferred shareholders had asserted injury resulting from the control and mismanagement by Standard, and that Standard's interest in the assets of Deep Rock would be subordinated, or reduced to a secondary status, to that of the preferred shareholders.³⁶⁶

In *Pepper*, the court affirmed the subordination of the controlling shareholder's claim based on a finding that the shareholder had engaged in a "planned and fraudulent scheme" to deprive another creditor of her just debt.³⁶⁷ The Court ruled that a controlling shareholder occupies a fiduciary capacity.³⁶⁸ Actions by such a fiduciary can be set aside or subordinated, but "[t]he essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."³⁶⁹

Rock needed to refinance its debt obligations, Standard accepted common stock in order to eliminate the large credit balance owing to Standard at that time. *Id.* at 321.

³⁶⁶ *Id.* at 324.

³⁶⁷ *Pepper*, 308 U.S. at 312. *Pepper* brought suit against the corporation for an accounting of certain lease royalties. Thereafter, the controlling shareholder, Litton, sued the corporation for five years of accumulated and unpaid salary claims. Litton caused the corporation to confess a judgment for his claims. Finally, after *Pepper* obtained a judgment, Litton obtained a suspension of the judgment to allow time for an appeal. However, in lieu of appealing, Litton executed upon his own judgment during the period of suspension. *Id.* at 297. At a sheriff's sale, the corporate property was sold to Litton, with Litton promptly reselling the property at a value more than six times higher than Litton had paid. *Id.* at 298. Litton thereafter caused the corporation to file voluntary bankruptcy and Litton purchased wage claims against the corporation in an attempt to make it appear that *Pepper* was the only creditor. *Id.* at 298-99.

³⁶⁸ *Id.* at 306.

³⁶⁹ *Id.* at 306-07. The court stated:

[A] sufficient consideration [whether claims will be subordinated] may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own perferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that

Since *Taylor* and *Pepper*, the courts have outlined three essential conditions for application of the equitable subordination principles:

- (i) The claimant must have engaged in some type of inequitable conduct;
- (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant;
- (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.³⁷⁰

Under the foregoing standards, mere proof of a fiduciary relationship is insufficient to subordinate a claim.³⁷¹ However, "inequitable conduct" sufficient to support subordination includes fraud, illegality, breach of fiduciary duties, undercapitalization, or use of the debtor as an instrumentality or alter ego.³⁷²

In the construction loan context, the Mississippi Supreme Court in *Peoples Bank & Trust Co. v. L & T Developers, Inc.*³⁷³ set forth a test for determining when equitable subordination is appropriate. The two prong test requires proof that a significant amount of the funds disbursed by the lender did *not* actually go into the construction project and that the construction lender failed to use reasonable diligence to assure that the funds being disbursed were actually being used for the project.³⁷⁴

Where equitable subordination is applied, the appropriate remedy is to counter the harm that other creditors suffered as a result of the inequitable conduct by shifting the priority of the wrongful party's claim below that of innocent creditors. When

power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

Id. at 310-11.

³⁷⁰ *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977)(citations omitted).

³⁷¹ *In re Missionary Baptist Found. of Am.*, 712 F.2d 206, 212 (5th Cir. 1983).

³⁷² *Id.*

³⁷³ 434 So. 2d 699 (Miss. 1983).

³⁷⁴ *Id.* at 707; *see also* *In re Century Inns, Inc.*, 59 Bankr. 507, 525-26 (S.D. Miss. 1986)(equitable subordination denied where neither *Peoples Bank* test nor *Mobile Steel* test satisfied).

properly applied, the doctrine of equitable subordination is intended to merely undo the advantage obtained over other creditors by the wrongdoing party.³⁷⁵

The doctrine is not penal in nature. Therefore, monetary damages are inappropriate. For this reason, commentators have suggested that "courts may be more willing to find control when the consequences of that finding will be less severe."³⁷⁶ However, in certain instances, the courts have exceeded the intent of the doctrine and ordered that the wrongful party's claim be subordinated to the claims of *all* other creditors, irrespective of whether such other creditors suffered harm.³⁷⁷ The result, for all practical purposes, is the equivalent of a monetary award.³⁷⁸

One commentator, Leo Clarke, has analyzed the concept of a fiduciary obligation as it applies in a leveraged buyout situation.³⁷⁹ Clarke proposes that control should be the focal point for a determination whether a fiduciary obligation exists.³⁸⁰ Clarke notes that typically a leveraged creditor will take a security interest in the debtor's assets, require a pledge of stock, and most probably impose certain affirmative or negative covenants upon the operation of the debtor's business. In Clarke's opinion, such covenants constitute sufficient control to impose a fiduciary obligation if management's power to handle changing circum-

³⁷⁵ See generally DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 BUS. LAW. 417, 423 (1985) ("[T]he goal should be merely to offset the harm done to other creditors and not to punish the offending creditor for his wrongful conduct.").

³⁷⁶ Schechter, *supra* note 11, at 880 n.12. Schechter notes that the effect is the same as a monetary award if the debtor is gravely insolvent and the lienholders who attain higher priority have claims equal to or in excess of the assets released by the subordination. *Id.*

³⁷⁷ See, e.g., *In re Process-Manz Press, Inc.*, 236 F. Supp. 333 (N.D. Ill. 1964), *rev'd* on other grounds, 369 F.2d 513 (7th Cir. 1966), *cert. denied* 386 U.S. 975 (1967). For a discussion of the punitive nature of subordination, see Chaitman, *The Equitable Subordination of Bank Claims*, 1 ABA 127, 137-142 (1987).

³⁷⁸ See Chaitman, *supra* note 377, at 130-144 (discussion of subordination as remedy).

³⁷⁹ Clarke, *supra* note 97, at 423 (1984). A leveraged buyout is a method of acquiring a company with a minimal investment as compared to the purchase price. Generally, outside lenders fund the purchase price, and the assets of the acquired company stand as collateral for the debt. The borrower is often the acquired company itself. *Id.* at 423, n.1.

³⁸⁰ *Id.* at 427.

stances is restricted.³⁸¹ Likewise, Clarke considers the typical lender to be a fiduciary, based upon the lender's ability to exercise powers pursuant to the loan agreement.³⁸²

Clarke's theory fails to give proper accord to the fact that loan agreements are entered into based on arms' length negotiations, with attendant bargained for consideration. Clarke states "[a] basic assumption underlying the fiduciary principle is that a party with any choice would not enter into a relationship in which it becomes subject to the control of another unless it believed there were some inherent limits on that control."³⁸³ However, by the same token, a basic premise underlying the lending process is that the financier would not enter into a creditor/debtor relationship unless it believed it had certain rights available to protect its interests.³⁸⁴

The lender/borrower relationship, standing alone, should never create a fiduciary relationship under Mississippi law. As discussed throughout this section, the lender must somehow misuse his status to the detriment of a third party. The "misuse" required for liability must be egregious, and not merely an exercise of rights inherent in the creditor/debtor relationship.

C. The Tort Theories

1. Fraud and Intentional Misrepresentation

Where control is absent and fiduciary principles or equitable subordination are inapplicable, theories of fraud and/or intentional misrepresentation have been asserted in an attempt to impose liability against lenders. However, as evidenced by the decision in *Union Bank v. Belk*,³⁸⁵ the underlying philosophy of *Krivo* remains alive. Lenders cannot be expected to go to the

³⁸¹ *Id.* at 439.

³⁸² *Id.* at 452. "They [lenders] are fiduciaries because the covenants and the security interest give them control over the corporate enterprise and over the interest of other persons in that enterprise." *Id.* Clarke further states that "the more stringent the covenants, the more control the creditor has, and the more likely it is that the creditor is a fiduciary to at least some interest in the corporation." *Id.* at 439.

³⁸³ *Id.* at 434.

³⁸⁴ See also *Keker & Hunt, supra* note 94, at 38-48 (1983)(discussion of liability of non-fiduciaries).

³⁸⁵ 510 F. Supp. 1117 (W.D.N.C. 1981).

grave with a dying corporation. The lender justifiably can protect its interests and limit its exposure. As such, substantial adverse acts by the lender must be proven to warrant disturbing the lender's rights to protect its interests. In *Union Bank*, Union Bank of Bavaria (UBB) sued the personal guarantor of a \$2,000,000 loan to Avery's, Inc.³⁸⁶ The guarantor, Belk, raised the affirmative defense that the bank had induced his personal guaranty through fraudulent misrepresentations.³⁸⁷ Specifically, Belk asserted that UBB had promised to make a \$3,000,000 long-term revolving loan to Avery's, Inc. when, in fact, at the time the representations were made, UBB had no intention of making such loan, and that such misrepresentations had damaged Belk. The court noted that promises to make future loans are actionable as fraud only if the promisee changes his position in reliance thereon. "A mere broken promise does not constitute fraud."³⁸⁸ Assuming *arguendo* that Belk's contentions were true, the court ruled that UBB's promise had "little relevance" to the guaranty — i.e., Belk could prove no reliance on the loan commitment promise. Instead, the court found that Belk had signed the guaranty at a time when Avery's Inc. was already in default in order to prevent financial disaster of the corporation. The court thought it inconceivable to charge the bank with fraud for "deciding that it had pumped enough of its capital into an ailing corporation."³⁸⁹

The United States Court of Appeals for the Second Circuit likewise rejected allegations of fraud and misrepresentation against a bank in *Ford v. C.E. Wilson & Co.*³⁹⁰ In *Ford*, the plaintiff, a supplier of roses, sued the bank after it failed to receive payment for a shipment to C.E. Wilson & Co. (Wilson).³⁹¹ The evidence established that about one week prior to the shipment Wilson applied for a \$6,500 loan from the bank. Although

³⁸⁶ *Id.* at 1119. After Avery's, Inc. defaulted on a \$2,000,000 loan to the bank, UBB obtained a personal guaranty from Belk and J. Richard Avery for the principal and interest owed on the indebtedness in the sum of \$2,086,305.56. *Id.*

³⁸⁷ *Id.* Belk also asserted other defenses to the action.

³⁸⁸ *Id.*

³⁸⁹ *Id.* at 1120.

³⁹⁰ 129 F.2d 614 (2d Cir. 1942).

³⁹¹ *Id.* at 615.

Wilson provided the bank with a financial statement which indicated that Wilson was solvent, the bank nevertheless demanded several forms of security as a condition to loaning the money,³⁹² all of which were agreed to by Wilson. When Wilson defaulted on the bank's loan, the bank applied accounts receivable collections against the balance owed and foreclosed on Wilson's equipment.³⁹³ Plaintiff sued the bank, alleging two primary counts based on interference with contract³⁹⁴ and fraud.³⁹⁵

As to the claim of fraud, the court rejected the plaintiff's argument that the bank had concealed its plan whereby it induced Wilson to receive the roses with the intention that the shipment never be paid for. The court found no evidence that the bank had knowledge of Wilson's insolvency, and concluded that, even if the bank had reason to believe that Wilson could not pay for the roses, such belief was not indicative of any intent not to pay.³⁹⁶ Finally, the court summarily rejected the plaintiff's contentions that the pledges and assignments were fraudulent in that the bank had concealed its preferential position from other creditors, stating:

There was no requirement that the Bank should notify the creditors that it held assignments of accounts receivable. The failure to notify them or even the desire not to have the assignments known was not a fraud when unaccompanied by any representation to the creditors that it did not hold the

³⁹² *Id.* The bank required Wilson to (1) lease the basement and a room on the main floor of Wilson's warehouse to the bank, (2) pledge all equipment, nursery stock and chattels, then owned and after acquired, to the bank, (3) assign all accounts receivable, including future accounts to the bank, (4) allow the bank's agent to take possession of the leased property and all pledged property, and (5) deposit all accounts receivable payments in a special account with a trust company. *Id.*

³⁹³ *Id.* at 616.

³⁹⁴ See *infra* notes 430-441 and accompanying text.

³⁹⁵ *Ford*, 129 F.2d at 616. Plaintiff's fraud count asserted that the bank had concealed the existence of the pledges, assignments, and lease from creditors, and that the bank had loaned the \$6,500 to Wilson for the sole purpose of keeping his business alive for a four month period in order that the foregoing transfers would not be voided as unlawful preferences. Plaintiff also asserted that the bank had "fraudulently made it appear that Wilson was a solvent going concern, by operating the business in the name of Wilson when the latter's property had been in fact appropriated by the Bank." *Id.*

³⁹⁶ *Id.*

security.³⁹⁷

Like the courts in *Union Bank* and *Ford*, Mississippi requires clear and convincing proof to establish fraud.³⁹⁸ Fraud is difficult to prove and the absence of any element in the cause of action results in failure of the claim.³⁹⁹

Although allegations of fraudulent misrepresentation are universally difficult to sustain, the plaintiff in *Central States Stamping Co. v. Terminal Equipment Co.*⁴⁰⁰ successfully proved such assertions and obtained a jury verdict of \$50,000, which was affirmed on appeal. The evidence established that the plaintiff contacted a bank officer to inquire about a company from whom the plaintiff contemplated placing an order for a specially manufactured machine. The plaintiff contended that it made a down payment of \$30,000 and one progress payment of \$20,000 for the machine based on the bank's representations that the manufacturing company was "maintaining a satisfactory credit relationship with the Bank and was trustworthy."⁴⁰¹ The plaintiff proved that, at the time the representations were made by the bank, the manufacturing company was in fact in default on two loans with the bank and its financial stability uncertain.⁴⁰² To aggravate the situation, the plaintiff also proved that the bank had benefited from its false statements in that the \$30,000 payment by the plaintiff was used by the bank to offset debts owed by the manufacturing company.⁴⁰³

The bank appealed the adverse judgment on the grounds that a "misrepresentation" could not be based on a failure to disclose, unless some duty to disclose existed.⁴⁰⁴ The court sum-

³⁹⁷ *Id.* at 618.

³⁹⁸ *Franklin v. Lovitt Equip. Co.*, 420 So. 2d 1370, 1373 (Miss. 1982). See *supra* notes 196-199 (discussion of elements of fraud).

³⁹⁹ See, e.g., *Champion Int'l v. First Nat'l Bank*, 642 F. Supp. 237, 241 (S.D. Miss. 1986) (plaintiff's allegations of fraudulent misrepresentations failed where plaintiff did not establish bank's knowledge of falsity of statements, nor intent that plaintiff rely on statements, nor damages resulting from alleged reliance).

⁴⁰⁰ 727 F.2d 1405 (6th Cir. 1984). See *supra* note 167 and accompanying text.

⁴⁰¹ *Central States Stamping*, 727 F.2d at 1407.

⁴⁰² *Id.* at 1408.

⁴⁰³ *Id.* at 1409.

⁴⁰⁴ *Id.* at 1408. The bank also asserted that its statements could at most constitute an opinion, which could not be used as the foundation for a fraudulent misrepresenta-

marized the law as follows: "The duty to speak does not depend on the existence of a fiduciary relationship between the parties. It may arise in any situation where one party imposes confidence in the other because of that person's position, and the other party knows of this confidence."⁴⁰⁵ Of special relevance was the fact the bank benefited from the plaintiff's action. The court stated "[t]he duty [to disclose] is particularly clear when the party answering the inquiry benefits directly from the actions of the inquiring party."⁴⁰⁶ The court concluded the bank had actual knowledge that the plaintiff considered the requested credit information material to its decision and that the plaintiff would rely on the bank's response in making a purchase decision. As such, the court ruled the bank had a duty to disclose all information in its knowledge which would be considered material to the plaintiff's decision.⁴⁰⁷

2. Negligent Misrepresentation

Where an intended misrepresentation cannot be established, third parties still have one avenue for relief — the theory of negligent misrepresentation. The polestar lender liability decision addressing negligent misrepresentation is the Mississippi case, *Berkline Corp. v. Bank of Mississippi*.⁴⁰⁸

In *Berkline Corp.*, a creditor⁴⁰⁹ sued the bank for actual and

tion. *Id.* The court disagreed, finding that the bank's statement that the manufacturing company was meeting its commitments to the bank, when in fact it was in default, was a misrepresentation of fact. The court further remarked that "where there has been a failure to disclose fully accompanied by a duty to speak, statements of favorable opinion may have the effect of lulling the inquirer into a less searching probe." *Id.* at 1409.

⁴⁰⁵ *Id.*

⁴⁰⁶ *Id.*

⁴⁰⁷ *Id.* Relying on an English case, the court reasoned that a bank faced with a credit inquiry has three options: (1) refuse to answer, (2) give a qualified answer, denying all responsibility for the response, or (3) give an unqualified answer. Where the bank gives an unqualified answer, the bank "can be held to have accepted some responsibility for answering carefully or to have accepted a relationship with the inquirer which requires him to exercise such care as circumstances require." *Id.* (emphasis added). "Responsibility" apparently refers to an expectation that the bank will exercise reasonable care in answering inquiries, while the "relationship" imposed by answering apparently refers to the confidence reposed in the bank by the inquirer.

⁴⁰⁸ 453 So. 2d 699 (Miss. 1984).

⁴⁰⁹ *Id.* at 700. The creditor, Berkline Corporation, was a Delaware corporation en-

punitive damages,⁴¹⁰ allegedly suffered as a result of a credit report prepared by the bank regarding one of its customers.⁴¹¹ The creditor asserted that the credit report included material false statements,⁴¹² the creditor relied on such report in extending credit to the customer,⁴¹³ and suffered losses as a direct result thereof.⁴¹⁴

The Circuit Judge dismissed the case, ruling that in a claim for fraudulent misrepresentation, the elements of fraud must be proved.⁴¹⁵ However, the Mississippi Supreme Court reversed and remanded for trial on a negligent misrepresentation theory.⁴¹⁶ The court concluded that a bank has no duty to provide credit references for customers and can incur no liability for refusing

gaged in the wholesale business of furniture to retailers for resale. *Id.*

⁴¹⁰ *Id.* at 701.

⁴¹¹ *Id.* at 699. The customer was Furniture City, Inc., a Tennessee corporation engaged in the retail sale of furniture. Furniture City, Inc. did its banking business at a branch of the Bank of Mississippi in Olive Branch, Mississippi. *Id.* at 700.

⁴¹² *Id.* at 700. The credit report furnished to Berkline Corp. stated that Furniture City had a line of credit with the bank in the low six figure range, a savings account in the low six figure range, and a commercial checking account with an average balance in the low five figure range. *Id.* At trial, Berkline Corp. introduced evidence that there were in fact no savings and checking accounts as stated by the bank, and further that Furniture City was indebted to the Bank in the amount of \$50,000-\$60,000. *Id.* at 701.

⁴¹³ *Id.* Essentially, Berkline Corp. contended it would not have sold goods to Furniture City on credit if it had known the true status of Furniture City's financial affairs. *Id.*

⁴¹⁴ *Id.* at 700-01.

⁴¹⁵ *Id.* at 701; see *supra* notes 196-199 and accompanying text.

⁴¹⁶ *Belkline*, 453 So. 2d at 703. The court identified the elements of a claim for negligent misrepresentation:

- (a) A misrepresentation or omission of a fact;
- (b) That the representation or omission is material or significant;
- (c) That in responding to the credit inquiry the bank officer failed to exercise that degree of diligence and expertise the public is entitled to expect of reasonably competent bank officers;
- (d) That it reasonably relied upon the bank's misrepresentation or omission; and
- (e) That it suffered damages as a direct and proximate result of such reasonable reliance.

Id. at 702; see also *White v. Hancock Bank*, 477 So. 2d 265, 271 (Miss. 1985) ("Fundamental requisites to a claim for negligent misrepresentation is that the party making the representation did so under circumstances where he has been engaged to make the representation and reasonably should be foreseen that the other would rely substantially thereon."; court found no "engagement" where plaintiff did not seek financial advice from bank and plaintiff had personal attorney present at closing).

to do so.⁴¹⁷ However, where a bank does act, even though without compensation, it must use that degree of care and diligence expected by the public of a reasonable bank officer;⁴¹⁸ otherwise, the bank may be subject to liability.⁴¹⁹

⁴¹⁷ *Berkline Corp.*, 453 So. 2d at 702.

⁴¹⁸ *Id.* The United States District Court for the Southern District of Mississippi discussed the degree of care and diligence expected of bank officials in *Champion International Corp. v. First National Bank*, 642 F. Supp. 237 (S.D. Miss. 1986). The court ruled that the bank officers failed to exercise reasonable care and diligence where they failed to communicate with one another regarding the availability of a letter of credit for a customer. *Id.* at 242.

⁴¹⁹ *Berkline Corp.*, 453 So. 2d at 702. The court noted that because of the bank's "unique position to know of the customer's credit worthiness", banks know or should know that third parties will rely upon credit information supplied by the bank. *Id.* As such, banks have an obligation to insure that representations are accurate. *Id.*

In reaching its conclusion, the Mississippi Supreme Court relied upon *Nevada National Bank v. Gold Star Meat Co.*, 89 Nev. 427, 514 P.2d 651 (1973) and *Anchor Lumber Corp. v. Manufacturers' Trust Co.*, 242 A.D. 656, 272 N.Y.S. 610 (1934). In *Nevada National Bank v. Gold Star Meat Co.* made a credit inquiry to Nevada National Bank regarding Holiday Ranch Beef, Inc. *Nevada National Bank*, 514 P.2d at 652. After the bank responded that Gold Star could safely extend up to \$8,000 credit to Holiday Ranch Beef, Gold Star delivered two shipments of beef. However, Holiday Ranch's check in payment for the beef was returned, marked "insufficient funds." *Id.* at 653. Gold Star later discovered that on the date of the credit inquiry Holiday Ranch had no account with Nevada National Bank, although its parent corporation did have a deposit account. *Id.* at 652. A judgment in favor of Gold Star against the bank for the amount of the check plus attorneys' fees was affirmed. *Id.* at 654. The court ruled that where a bank responds to a credit inquiry it has a duty to reply with correct information and may be liable where negligence or carelessness causes a misrepresentation of facts within the bank's knowledge. *Id.* at 653-54. The court noted that the bank "could have requested written authorization for such a disclosure with attendant releases and disclaimers." *Id.* at 653; see also *Union Bank v. Safanie*, 5 Ariz. App. 342, 427 P.2d 146, 151 (1967)(bank held liable to stock brokerage firms for falsely stating that depositor's check for purchase of stock would clear through bank account; court ruled that "where the defendant had adopted a practice of imparting credit information to local businessmen, it should not complain that plaintiffs ought not to have trusted such information, unless such trust was manifestly unreasonable"); *Anchor Lumber Corp.*, 272 N.Y.S. at 611 ("We think there was a duty, in view of the bank's relations to the public, to speak carefully when the defendant's employee undertook to speak at all. The inquiry of the bank clearly imported a merchant's purpose to rely upon the information, and rely upon it it did to its loss."); *Gartner v. American Nat'l Bank*, 58 So. 2d 705, 708 (Fla. 1952)(summary judgment granted to defendant bank where plaintiff alleged loss as result of bank employee's representations that depositor's checks were as good as gold). But see *White*, 477 So. 2d at 270 (alleged statement by bank official that check "looked all right to him or that he saw nothing wrong with it or something of that nature" held to be opinion); *Bullard v. Citizens Nat'l Bank*, 173 Miss. 450, 160 So. 280, 282 (1935)(statement by bank officer that bonds sold to customer were "gilt-edged and as good as gold" held to be mere statement of opinion and inactionable against bank); *Albion Milling Co. v. First Nat'l Bank*,

The Mississippi Supreme Court imposed liability on a bank for negligent misrepresentation in *Shogyo International Corp. v. First National Bank*.⁴²⁰ First National Bank of Clarksdale (FNBC) issued a letter of guaranty to Shogyo in behalf of Co-Products Unlimited, Inc. (Co-Products), for which Shogyo supplied Co-Products with an initial order of wheel casters.⁴²¹ On two subsequent occasions, the same system was used to place additional orders — i.e., Co-Products notified FNBC that an order of casters was needed, FNBC issued a letter of guaranty to Shogyo, and Shogyo thereafter shipped the goods to Co-Products.⁴²²

On February 5, 1980, Co-Products submitted a purchase order to Shogyo for 150,000 wheel casters on "usual" terms.⁴²³ Thereafter, on February 19, 1980, FNBC sent a letter to Shogyo stating that Co-Products had made financial arrangements with the bank for the purchase of the casters.⁴²⁴ In a letter to FNBC dated March 4, 1980, Shogyo outlined its understanding of the Bank's guarantee for the casters, and requested that FNBC initial and return the letter. Although FNBC did not respond, shipments of the casters were nevertheless made. The Bank refused payment for the shipments, and Shogyo filed suit to re-

64 Neb. 116, 89 N.W. 638, 640 (1902)(bank cashier told proposed supplier of merchandise that to his knowledge customer seemed to be doing well, that all debts were paid, and that credit extension of about \$500 would probably be good; court held such statements could only be considered an expression of opinion and supplier was able to form his own opinion regarding extension of credit since cashier fully disclosed all information he knew); *Taylor v. Commercial Bank*, 174 N.Y. 181, 66 N.E. 726, 729-30 (1903)(court ruled that bank employee had no apparent or implied authority, by virtue of position as cashier, to make any representations on behalf of bank as to solvency of customer and bank could not be held liable for damages resulting from such representations). For an interesting, yet unsuccessful, attempt to impose liability on a bank for credit information under a theory of malicious interference with contractual relations, see *Irby v. Citizens National Bank*, 239 Miss. 64, 121 So. 2d 118 (1960).

⁴²⁰ 475 So. 2d 425 (Miss. 1985).

⁴²¹ *Id.* at 425.

⁴²² *Id.* at 426.

⁴²³ *Id.* "On 'usual' terms" was understood by Shogyo and Co-Products to mean guaranteed by FNBC. *Id.*

⁴²⁴ *Id.* In full, the letter stated "Co-Products Limited, Inc. has made financial arrangements with us to purchase 150,000 casters at \$.43 each in shipments of 50,000. It is our understanding the first shipment will arrive in June. We appreciate your working with Co-Products Limited, Inc. on this matter." *Id.*

cover payment.⁴²⁵

FNBC contended its letter was not one of guaranty, but only a letter of thanks to Shogyo for granting credit to Co-Products. FNBC further contended that it would not have issued a letter of guaranty because at the time the letter was written Co-Products was in poor financial condition and no arrangements had been made for financial assistance.⁴²⁶

The court held that the elements of negligent misrepresentation, as set forth in *Berkline Corp.*, were satisfied. The court determined the Bank's statement that Co-Products had made financial arrangements for the purchase of the casters was an untrue statement of fact which the bank should have known Shogyo would act upon.⁴²⁷ As such, FNBC was under a *duty* to disclose the information necessary to correct its prior misrepresentations.⁴²⁸

Berkline Corp. and *Shogyo* are warnings to Mississippi lenders: even though allegations of control or fiduciary obligations are impossible, lenders may nevertheless be liable to third parties for statements or omissions made in the course of business. The absence of compensation to the bank for such representations is irrelevant. Therefore, as an avoidance technique to liability, lenders should assert disclaimers when supplying credit information and/or obtain releases of liability from the person or entity to whom the information is provided.⁴²⁹

3. Tortious Interference With Contract

Third parties have also attempted to impose liability on lenders for interference with their own contractual relationship with the borrower. As in the borrower liability cases discussed earlier, the decisive issue frequently is whether the lenders' ac-

⁴²⁵ *Id.* at 427.

⁴²⁶ *Id.* at 426-27.

⁴²⁷ *Id.* at 427.

⁴²⁸ *Id.* at 428.

⁴²⁹ See also *First Nat'l Bank v. Langley*, 314 So. 2d 324 (Miss. 1975)(en banc)(although action stemming from loss of customer's deposit founded on negligence, court imposed form of fiduciary obligation extending not only from bank to its customers, but also to customers' employees).

tions were privileged.⁴³⁰

A lenders' privilege argument was rejected by the Wyoming Supreme Court in *First Wyoming Bank v. Mudge*.⁴³¹ The Mudges sold their welding business to Redding.⁴³² The purchase agreement contained a nonencumbrance clause which prohibited Redding from mortgaging any of the purchased assets for more than the existing debt without the Mudges' consent.⁴³³ Despite knowledge of the foregoing provision, the bank loaned Redding \$100,000 secured by assets of the welding business.⁴³⁴

When Redding defaulted, the bank foreclosed on the assets. The Mudges obtained a \$100,000 letter of credit to secure a release of the bank's lien. Later the bank drew down the full amount of the letter of credit.⁴³⁵

The Mudges successfully sued the bank for interference with their contractual relationship with Redding.⁴³⁶ The court rejected the bank's privilege argument because the bank acted in bad faith.⁴³⁷

The opposite conclusion was reached in *Ford v. C.E. Wilson & Co.*⁴³⁸ In *Ford*, the plaintiff asserted that the pledge of roses as collateral for a bank loan and the assignment of the account receivables had rendered it impossible for the purchaser, Wilson, to pay for the shipment, thereby inducing Wilson to break its contractual obligations with the plaintiff.⁴³⁹ As to the claim of interference, the court equated the plaintiff's allegations to a claim that "a creditor who takes security under circumstances rendering payment of the claims of other creditors unlikely is liable in tort."⁴⁴⁰ The court rejected such an argument. The

⁴³⁰ See *supra* note 240 and accompanying text (discussion of privileges available to lenders).

⁴³¹ 748 P.2d 713 (Wyo. 1988).

⁴³² *Id.* at 714.

⁴³³ *Id.* at 714-15.

⁴³⁴ *Id.* at 715.

⁴³⁵ *Id.*

⁴³⁶ *Id.* The Mudges recovered the face amount of the letter of credit, its purchase cost and interest. *Id.*

⁴³⁷ *Id.* at 716-17.

⁴³⁸ *Ford*, 129 F.2d at 614; see *supra* notes 390-397 and accompanying text.

⁴³⁹ *Ford*, 129 F.2d at 616.

⁴⁴⁰ *Id.* at 617.

court considered it reasonable for the bank to require collateral as a condition to a loan, noting that Wilson had the opportunity to accept or reject such requirements. The court determined that the bank had given valuable consideration for the security, and therefore "had a privilege to interfere with the plaintiff's contracts and expectancies because it was 'acting under an equal or superior right' when seeking security for its own advances."⁴¹

III. CONCLUSION

As noted throughout this article, the authors are of the opinion that Mississippi courts should reject lender liability theories which restrict the lenders' ability to enforce the terms of their loan agreements. Lenders include in these agreements provisions designed to minimize their losses if a loan goes sour. Borrowers recognize the purpose of these provisions when they sign the loan agreement. Other creditors of the borrower are free to impose similar conditions or to refuse credit. Restricting the enforceability of these provisions undermines the risk allocation understood by all parties at the initiation of their credit arrangement and impinges on the lender's right to protect its own economic interests. Absent fraud or other illegality, lenders should be permitted to rely on their contractual rights in extending and collecting their loans.

⁴¹ *Id.* at 617. *But see* *Melamed v. Lake County Nat'l Bank*, 727 F.2d 1399, 1404 (6th Cir. 1984)(court ruled that lender's memorandum setting forth plan to "help salvage whatever possible" from debtor situation could be interpreted as improper interference, and evidence was sufficient to take claim to jury); *Irwin & Leighton, Inc. v. W.M. Anderson Co.*, 532 A.2d 983, 993 (Del. Ch. 1987)(factual dispute existed as to Fidelity's participation in subcontractor/debtor's decision to repudiate contract with prime contractor).