Termination of Credit for the Farm or Ranch: Theories of Lender Liability

by

Steven C. Bahls

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* Assistant Professor of Law, University of Montana School of Law; B.B.A., University of Iowa, 1976; J.D., Northwestern University, 1979. The author gratefully acknowledges the research assistance of Tonya D. Bumbarger.

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I. Introduction

As the number of failed farm and ranch operations increases, so does the number of lawsuits involving claims that lenders are responsible for farmers' losses. These lawsuits are precipitated by what the farmer perceives to be a sudden refusal to extend additional credit, a sudden acceleration of a loan or an unexpected refusal to renew credit. The theories farmers assert against farm lenders range from breach of contract to breach of an implied covenant of good faith and fair dealing. These claims generally arise in one of two forms: a direct action by the farmer against a lender or a counterclaim to the lender's foreclosure suit. Because there are a limited number of reported cases that analyze the sudden or unexpected termination of farm credit, courts are struggling to develop standards against which to evaluate a lender's conduct.

Perhaps the most publicized case involving farm liability is *Jewell v. Bank of America.*[1] In *Jewell*, the jury awarded $22 million for punitive damages to apple farmers who claimed they were injured by the sudden termination of credit by Bank of America.[2]

1. No. 112439 (Superior Ct. of Cal., Co. of Sonoma 1985). This case is under appeal.
2. Jewell alleged that he was encouraged by the Bank of America to loan funds to his

The trial court reduced the punitive damages to $5 million and let the award of $17 million in general damages stand.[3] The *Jewell* case is not alone. An Iowa jury awarded an Iowa farmer $1.5 million in damages and ordered the lender to forgive an additional $645,000 of indebtedness as a result of alleged false promises of new loans.[4] In states such as Montana, where the state supreme court has implied a covenant of good faith and fair dealing into a wide variety of contracts, counterclaims against banks in foreclosure actions alleging breach of the implied covenant are now asserted almost as a matter of course. These suits and counterclaims represent a real threat to banks in farm communities,[5] many of which are already in a weakened condition.

The increase in the number of lawsuits against farm lenders[6] is attributable, in part, to the changing attitude of farm lenders toward farm operations. Until the farm crisis of the 1980s, many lenders rushed to make loans to farmers. Farm lenders often paid employees bonuses based on loan volume initiated. One way lenders initiated new loans was to build a reputation that the lender would stand behind the farmer through "thick and thin."[7] Lenders

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customer, James E. O'Connell Co., to pay the customer's anxious creditors. Jewell borrowed $150,000 from the Bank of America over a period of time to help O'Connell, based on a bank officer's agreement to "take care of the debts" by refinancing the loan later. Jewell claimed Bank of America later disclosed that it considered management skills to be inadequate. Jewell's loan to keep O'Connell afloat, according to the evidence, ultimately benefitted Bank of America since O'Connell's largest creditor was a Bank of America customer. This fact was never disclosed to Jewell. For a discussion of the *Jewell* case, *see* Bahls & Bahls, *Farmers Fight Back*, FARM J., Mid-January 1987 at 21; Hidas, *Apple Wars*, SONOMA BUS., Summer 1986 at 84; Lehrman & Ludlow, *Financially Ailing Farmers Take Their Battle to the Courtroom*, San Francisco Examiner, March 19, 1986 1, col. 1; Levine, *An Apple Grower Takes a Bite out of B of A*, BUS. WK., November 11, 1985, at 114.

3. Hidas, *supra* note 2, at 93.

4. Levine, *supra* note 2, at 114. For a discussion of other leading cases, *see* Miller, *Lawyers Who Cash in on Lender Liability*, BANKERS MONTHLY, October 1986 at 19.

5. One bankers' magazine reports that the "threat" of lender liability "is sending chills down many a banker's spine." Stuart, *Lender Liability*, U.S. BANKER, May 1986, at 10. *See also*, Bahls & Bahls, *supra* note 2, at 21; Moss, *Borrowers Fight Back With Lender Liability*, 73 A.B.A.J. 5, 9 (March 1, 1981). The law concerning lender liability, according to one commentator, shows "signs of a truly glacial shift in the complex that constitutes the bank-customer relationship." *Counsel's Corner*, 104 BANKING L.J. 59, 59 (1987).

6. The Federal Revenue Board estimates that the farm real estate debt, in 1985, was held by the following groups: Farm Credit System, 44.04%, insurance companies, 11.02%, banks, 9.01%, Farmers Home Administration, 8.87%, individuals and others, 26.79%. *See Farm Credit Administration Act Amendments of 1985*, Before the Senate Comm. on Banking, Housing and Urban Affairs, 99th Cong. 2d Sess. 50 (1986) (statement of Randall A. Killebrew).

7. Kelley, *Some Observations on Lender Liability and Representing the Farmer/Borrower*, AGRIC. L. UPDATE, December 1986, at 4, 5. One bank newspaper advertisement stated: "We don't take a 'lend you and leave you' attitude toward our customers." *See The Bank Customer Relation: Part II — The Judicial Decisions*, 100 BANKING L.J. 325, 327 (1983).

often became the farmer's friend and financial adviser, sometimes encouraging the farmer to expand his business. As the farm crisis worsened, farmers' relationships with their lenders changed. Lenders stopped advancing money to expand operations and frequently conditioned new loans on a restructuring of the farm operation and farm debt.[8] Some lenders asked for additional security or required partial liquidation of operations as a condition of extending future credit. Farmers and ranchers were understandably dismayed at the relatively sudden change in the bankers' attitude. Eventually many lenders chose to minimize their losses by foreclosing and farmers and ranchers retaliated with suits against the lenders.

There are no clear standards to guide the judicial system when it must determine whether a lender is liable, when the lender, who has been willing (and eager) to make loans in the past, terminates credit relatively suddenly.[9] Attorneys pursuing these claims use a number of theories, which commonly include: breach of contract, fraud, interference with contract, negligence and breach of the implied covenant of good faith.[10] Courts struggle with these causes of action because of lack of precedent and because the breakdown of relationships between farm lenders and farmers does not always fit neatly into one of these causes of action.

This article describes the primary theories of liability asserted against lenders by farmers when credit is terminated. The discussion focuses on the difficulty that courts have with balancing varying interests of the borrower in fair treatment by the lenders and of the lender in making credit decisions (including decisions to terminate credit) in such a way as to benefit their owners.[11] This arti-

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Claims that lenders solicited the farmers' business are not uncommon. *See, e.g.*, Wait v. First Midwest Bank/Danville, 142 Ill. App. 3d 703, 705, 491 N.E.2d 795, 798 (1986).

8. Kelly, *supra* note 5 at 4, 5. The banks' hesitancy to extend credit was due to a worsening of the farm economy. World recession, United States trade policies (including the grain embargo of the Soviet Union), increased acreage in food production, increased production and debt service costs, and United States government farm policies all served to make farming less profitable. *See* U.S. Dep't of Agric. Econ. Research Serv., *Reviving U.S. Exports: Why Is It Taking So Long*, FARMLINE, Feb. 1985 at 15-18.

9. For a good discussion of theories used by bank borrower, *see* Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775 (1986), and Flick, II & Replansky, *Liability of Banks to Their Borrowers: Pitfalls and Protections*, 113 BANK. L.J. 220 (1986).

In states such as Montana, a spirited debate rages among the members of the Montana Supreme Court concerning what circumstances justify imposition of bank liability. Northwestern Nat. Bank v. Weaver-Maxwell, Inc., ___ Mont. ___, ___, 729 P.2d 1258, 1267-68 (1987) (Morrison, J., dissenting).

10. Ebke & Griffin, *supra* note 9.

11. The burden of bank failures, whether due to judgments against banks for "foul play" or the inability to collect their loans will ultimately rest on the American public because most banks are insured by the Federal Deposit Insurance Corporation.

cle then suggests standards against which to measure a lender's and borrower's conduct in order to determine whether a contract to extend or renew credit exists and whether the lender has committed any of the numerous varieties of fraud against the borrower. The article describes two theories asserted against lenders which are only beginning to develop: (a) negligence in processing a borrower's applications for loan renewals and (b) breach of the implied covenant of good faith and fair dealing when lenders terminate or fail to extend new credit. After a discussion of policy considerations, the article concludes that decisions to accelerate an existing loan should be treated differently than applications to extend new or additional credit when loans are due and unpaid. The decision to accelerate a loan because of a default in its terms should be evaluated against an objective good faith standard, while the decision to refuse to extend new or additional credit should not be measured against an objective good faith standard; rather, it should only be tested to determine whether a contract to extend credit exists or whether the bank has committed one of several varieties of fraud. In most events, however, the lenders should be expected to give borrowers reasonable notice of their intended actions. This article discusses why these standards represent a reasonable balance between the borrower's need for fair treatment and the lender's need to return a reasonable profit to its shareholders.

II. Theories Commonly Asserted

A borrower who suffers a sudden termination of credit frequently asserts more than one theory against the lender. Usually one of the theories is based in contract and the other is based in tort.[12] Both contract and tort theories will be analyzed.

A. *Contract Theories*

The statements and conduct of the borrower and lender prior to the due date of a loan may amount to a contract to refinance the existing debt when it becomes due or may give rise to a modification of the loan that extends the due date of the loan. When the borrower and lender do not agree whether a contract to extend

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12. *See, e.g.*, Betterton v. First Interstate Bank, 800 F.2d 732 (8th Cir. 1986); Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983); Sanchez-Corea v. Bank of Am., 38 Cal. 3d 892, 701 P.2d 826, 215 Cal. Rptr. 679 (1985); Wait v. First Midwest Bank/Danville, 142 Ill. App. 3d 703, 491 N.E.2d 795 (1986); Northwestern Nat'l Bank v. Weaver-Maxwell, Inc., ___ Mont. ___, 729 P.2d 1258 (1987); Central Bank v. Eystad, ___ Mont. ___, 710 P.2d 710 (1985); First Nat'l Mont. Bank v. McGuiness, ___ Mont. ___, 705 P.2d 579 (1985).

credit was made, the lender typically argues that it merely entered into negotiations, while the borrower argues that there was an offer and acceptance which amounted to a binding contract.

Alaska Statebank v. Fairco[13] is typical of the cases which discuss whether a bank officer's words and actions amount to an offer to extend the due date of a note. In *Fairco*, a retail shop failed to make a bank payment when it was due. The borrowers requested that the bank extend the due date of the note until after the Christmas season. There was conflicting testimony between the bank and the borrower about the conversations which took place concerning the extension of the due date. The supreme court noted the lower court's finding that the borrower left the meeting with the "impression" that the due date of the note was extended and affirmed the lower court's finding that "[t]he parties had agreed to such a modification, '[g]iven the course of dealings between the parties, the fact of the continued negotiation and the lack of outstanding demand for payment'."[14] The Alaska Supreme Court's conclusion may be criticized as a jumbled legal analysis. By examining the course of dealing and absence of demand and then concluding that the contract is modified, the court fails to focus on the critical elements necessary to modify a contract. As explained below, an analysis of course of dealing and conduct of the lender is more appropriate when testing the lender's actions for fraud or estoppel.[15] Unfortunately, the Alaska Supreme Court is not alone in misanalyzing whether the borrower's and lender's conduct is sufficient to create a contract. While the improper analysis may be attributable to the lack of precedent in loan extension cases, courts should adhere to certain basic tenets of contract law described below when evaluating each case.

To properly analyze whether a contract action may be maintained against a bank when credit is terminated, three separate questions must be analyzed:

> (1) Did the lender and borrower agree to an extension of new credit or a refinancing of existing credit?
>
> 2) Did the lender agree to modify the loan agreement in such a way as to extend the due date?
>
> 3) Did the lender *waive* its right to insist on timely payments

13. 674 P.2d 288 (Alaska 1983).

14. *Id.* at 292.

15. *See infra* text accompanying notes 31-44 & 59-69. Course of dealing is also appropriately analyzed to supply missing terms or disputed terms or to supplement or qualify the terms of the agreement, but not to supply offer and assent to a modification. E. FARNSWORTH, CONTRACTS §§ 7.13 at 508, & 3.28 at 196 (1982).

or is the lender *estopped* from insisting on timely payments?

If courts use this three-step analysis, their decisions will avoid muddled analysis of cases such as *Fairco* and will provide for greater certainty for both lenders and borrowers. This section discusses each of these questions, but does not attempt to describe thoroughly the elements necessary to make out a cause of action. Rather this section of the article focuses on the contract arguments which commonly arise in disputes which occur as a result of the bank's failure to extend credit.

1. *Commitment for New Financing or New Credit*

It is common for lenders and borrowers to engage in a discussion of whether a lender will refinance an existing loan and, perhaps, extend additional credit. If there is an agreement to refinance a loan or extend new credit, a borrower may properly sue for contract damages when the credit is not forthcoming. If the parties agree that the lender will make a loan or extend the due date of the loan and agree the "details" will be worked out later, there is an issue as to whether the terms of the agreement are sufficiently definite to justify a finding that the parties assented to the contract. In order to be sufficiently definite, the terms of the contract must "provide a basis for determining the existence of a breach and for giving an appropriate remedy."[16] Courts have held that for an agreement to loan money in the future to be sufficiently enforceable, there must be agreement on the material terms of the loan, including the due date(s), the interest rate, and the mode and rate of payment.[17] Some courts have found that these elements need only be proven with reasonable certainty.[18] For example, in *Wait v. First Midwest Bank/Danville*,[19] an Illinois Court of Appeals found that an interest rate was sufficiently definite when the parties agreed that it was "at the variable rate [then] charged" and that duration could be established "based upon custom in the area, the terms of the previous loan . . . or in considering the steps [the borrower] alleges he has taken to obtain the loan."[20] While courts have not required definite proof of every term of the contract, courts correctly require the party asserting the existence of the

16. RESTATEMENT (SECOND) OF CONTRACTS § 33(2) (1981).
17. Wait v. First Midwest Bank/Danville, 142 Ill. App. 3d 703, 708, 491 N.E.2d 795, 801 (1986); McErlean v. Union Nat'l Bank, 90 Ill. App. 3d 1141, 1146, 414 N.E.2d 128, 132 (1980).
18. *See, e.g.*, *Wait*, 142 Ill. App. 3d at 708, 491 N.E.2d at 801.
19. 142 Ill. App. 3d 703, 491 N.E.2d 795.
20. *Id.* at 708-09, 491 N.E.2d at 801.

contract to prove the major terms described in the *Wait* case. Finally, some courts have held that agreements that are "firm" but subject to "more definitive documentation" are not sufficiently definite to be enforceable.[21]

Because of the requirement of assent, courts should resist the temptation to find that, because the lender has extended credit in the past and then terminated credit without warning, it has therefore agreed to modify the contract to provide for a new due date. This does not amount to the necessary assent. Renewing credit in the past does not mean that one necessarily intends to renew credit indefinitely. The course of past dealing should not amount to sufficient assent to continue dealing, indefinitely, in that way when there is a clear due date expressed in the loan. It is well established that if the course of dealing (a pattern of renewal) is inconsistent with a written term (a specific due date of the loan), the evidence of course of dealing is not relevant.[22] Rather, the course of dealing may be properly examined to interpret the terms of the modification and may be examined to supplement or qualify the terms of the modification,[23] but not whether there is assent to a modification. As properly noted by the Kansas Supreme Court, "the mere fact that a bank has renewed loans in the past does not require it to do so in the future."[24]

2. *Modification of the Loan Agreements*

To modify a loan agreement, or any other contract, three elements must be present: assent, a writing (if the contract falls within the Statute of Frauds), and consideration or detrimental reliance.[25] Of these elements, most of the litigation surrounds the issue of assent. Usually borrowers avoid a Statute of Frauds problem because the claimed extension is a year or less. Usually the defense of lack of consideration is not a viable argument because prior debt is often sufficient consideration.[26] In the typical case, the lender has extended credit a number of times and has entered into negoti-

21. J. Russell Flowers, Inc. v. Itel Corp., 495 F. Supp. 88 (N.D. Miss. 1980).

22. *See generally* E. FARNSWORTH, *supra* note 15, § 7.13 at 512. Evidence of course of dealing may be relevant when determining whether the lender's conduct is tortious.

23. *Id.* at §§ 3.28 at 196 & 7.13 at 508. As previously stated, course of dealing, when used in the context of the *Fairco* case is more properly examined under theories of fraud and estoppel. *See* text accompanying notes 11 through 14 *supra*.

24. First Bank v. Moden, 235 Kan. 260, 264, 681 P.2d 11, 14 (1984).

25. E. FARNSWORTH, *supra* note 15, § 8.5 at 562-63.

26. Farmers State Bank v. Johnson, 188 Mont. 55, 62, 610 P.2d 1172, 1176 (1980). *See also* MONT. CODE ANN. § 28-2-802 (1985). *See also* E. FARNSWORTH, *supra* note 15, § 4.11 at 275-79 (1982).

ations to extend credit again. There is usually a dispute as to whether the lender, by its words or acts, modified the due date.

In order for assent to be sufficient to provide a basis for modification, the terms of the modification must be sufficiently definite.[27] When the issue is whether an extension of the due date of a loan is sufficiently definite, courts require a definite and certain time or a time computed with reference to a specific event.[28] Courts should not find that the term of the note has been extended to some indefinite date unless it is clearly the intent of the parties to convert the note to a demand note that requires a *definite* period of notice before payment is due.

In some states, such as Montana, a showing of oral assent to a modification will not be effective because of the statute providing written contracts cannot be modified except in writing or by an executed oral agreement.[29] These states, however, are in the minority and their statutes are inconsistent with common law.[30] In states with the minority rule, the issue then is not whether the lender's oral statements or actions serve to modify the loan, but whether the lender has waived certain rights under the loan or is estopped from asserting certain rights because of prior actions or statements.

3. *Waiver/Estoppel Theories*

Because it is frequently difficult for borrowers to prove the necessary facts to constitute assent to extend the due date, borrowers often rely on theories of waiver or estoppel to achieve the same result. When a lender accepts late payments on a note, the lender waives its right to accelerate payments due on the note or foreclose against the collateral supporting the note as a result of the late payments it accepted.[31] The waiver is usually effective even though the contract calling for the payments contains a clause that "time is of the essence"[32] or an anti-waiver clause.[33] Courts deciding

27. *See* RESTATEMENT (SECOND) OF CONTRACTS § 33(2) (1981).

28. Tsesmelis v. Sinton State Bank, 53 S.W.2d 461 (Tex. Ct. App. 1932); Keller v. Commercial Credit Co., 149 Or. 372, 40 P.2d 1018 (1935); and Pavey v. Collins, 31 Wash. 2d 864, 199 P.2d 571 (1948). Courts may, however, review circumstances outside the four corners of the loan agreements to determine the due date the parties intended. *See* Carrico v. Delp, 141 Ill. App. 3d 737, 490 N.E.2d 977 (1986).

29. MONT. CODE ANN. § 28-2-1602 (1985). *See* Winkel v. Family Health Care, ___ Mont. ___, 668 P.2d 208 (1983).

30. E. FARNSWORTH, *supra* note 15, § 7.6 at 474.

31. Suburban Homes Co. v. North, 50 Mont. 108, 145 P. 2 (1914). The result in the *Suburban Homes* case was recently confirmed in Bailey v. Lilly, ___ Mont. ___, 667 P.2d 933 (1983).

32. *Suburban Homes Co.*, 50 Mont. 108, 145 P. 2.

these cases properly reason that a lender, by its conduct, may waive its "time is of the essence clause" or anti-waiver clause.

A related and more difficult question, is whether a lender who establishes a pattern of accepting late payments has "waived" its right to insist on future timely payments or has consented to an extension of the due date of future payments. The argument in support of this position is that the indulgence of the lender in not insisting on, and enforcing, timely payments is evidence of an agreement that the borrower's failure to make timely payment is not a default.[34] Many courts hold that if a pattern of accepting late payments is established, lenders may not insist on strict compliance with the terms of the contract.[35] These courts find that because this course of conduct by the lenders lulls debtors into a habit of making late payments, it is inequitable to require timely payments without reasonable advance notice of the lenders' intentions to do so.[36] What constitutes reasonable advance notice has not been defined. Presumably, the notice must have been given a sufficient amount of time before the payment is due to enable a creditworthy borrower an adequate opportunity to find alternative financing.

Waiver of a lender's right to insist on timely payments, under certain circumstances, may be a proper defense to a lender's action to declare a default and subsequent acceleration of a note when an installment payment is not made on time. It is not, however, a proper argument to justify requiring a lender to extend a note which is already due. Waiver is not "the intentional relinquishment of a known right," as it is often said to be.[37] Rather, it is the excuse of the nonoccurrence or a delay of a condition. The failure to declare a default (within a condition of a loan) is different from the failure to renew a loan. A loan is properly renewed by a separate contract, not by the mere waiver of a default in an existing

33. Westinghouse Credit Corp. v. Shelton, 645 F.2d 869, 873 (10th Cir. 1981); Smith v. General Fin. Corp., 243 Ga. 500, 501, 255 S.E.2d 14, 15 (1979); Van Bibber v. Norris, 404 N.E.2d 1365, 1373-74 (Ind. Ct. App. 1980); Cobb v. Midwest Recovery Bureau Co., 295 N.W.2d 232, 237 (Minn. 1980); *contra* Hale v. Ford Motor Credit Co., 374 So. 2d 849, 853 (Ala. 1979); Fair v. General Fin. Corp., 147 Ga. App. 706, 250 S.E.2d 9 (1978); Universal C.I.T. Credit Corp. v. Middlesboro Motor Sales, Inc., 424 S.W.2d 409, 411 (Ky. Ct. App. 1968); Home Fin. Co. v. Frazier, 380 S.W.2d 91, 93 (Ky. Ct. App. 1964).

34. A similar analysis was used in *Suburban Homes*, 50 Mont. at 118, 145 P. at 5.

35. Westinghouse Credit Corp. v. Shelton, 645 F.2d 869, 873 (10th Cir. 1981); Nevada Nat'l Bank v. Huff, 94 Nev. 506, 513, 582 P.2d 364, 369 (1978); Knittel v. Security State Bank, 593 P.2d 92, 95-96 (Okla. 1979); Lee v. Wood Prod. Credit Union, 275 Or. 445, 448, 551 P.2d 446, 448 (1976).

36. Lee v. Wood Prod. Credit Union, 275 Or. 445, 448, 551 P.2d 446, 448 (1976).

37. E. FARNSWORTH, *supra* note 15, § 8.5 at 561.

contract.

Closely related to the theory of waiver is the theory of equitable estoppel.[38] Borrowers have successfully used the theory of equitable estoppel to preclude lenders from taking actions inconsistent with their oral statements in states that provide that written agreements may not be orally modified. The Supreme Court of Oklahoma properly applied the theory of estoppel to a bank which had orally waived a default as defined by the loan agreement.[39] Oklahoma is a state, like Montana, that provides that a contract in writing may only be altered in writing or by an *executed* oral agreement.[40] The Supreme Court of Oklahoma found that a bank was estopped from exercising its right to accelerate because the bank officer's statement assured the debtor that late payment was not considered to be a default. The court, quoting the Supreme Court of Utah, held:

> The imposition of such severe conditions [as acceleration upon default] is not favored in the law; and one who seeks to impose them must not, either by acts or omission permit another to assume that the covenant will not be strictly enforced, then "crack down" on the obligor by rigidly insisting on enforcement, without giving some reasonable notice and opportunity to comply.[41]

It would seem that the rationale set forth by the Supreme Court of Utah not only applies to accelerations of notes upon defaults, but

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38. The elements of equitable estoppel are best described in 2 J. Pomeroy, Equity Jurisprudence § 804 (4th ed. 1918), which provides:

> Equitable estoppel is the effect of the voluntary conduct of a party whereby he is absolutely precluded, both at law and in equity, from asserting rights which might perhaps have otherwise existed, either of property, of contract, or of remedy, as against another person, who has in good faith relied on such conduct, and has been led thereby to change his position for the worse, and who on his part acquires some corresponding right, either of property, of contract, or of remedy.

The concept of estoppel is frequently used by courts to allow recovery when there has been no offer because of insufficient definiteness. *See* Hoffman v. Red Owl Stores, 26 Wis. 2d 683, 133 N.W.2d 267 (1965). Commentators have criticized applying the notion of promissory estoppel to cases where there is no offer and have suggested that decisions "may fit better into that field of liability for blameworthy conduct that we know as tort, instead of that field of liability based on obligations voluntarily assumed that we call contract." E. Farnsworth, *supra* note 15, § 3.26 at 192. Farnsworth's criticism of using a promissory estoppel notion to prevent injustice when there is not a definite promise (e.g., the lender agrees to extend the loan to some unspecified due date) is appropriate in light of the well developed body of law relating to misrepresentation. When the issue of the sudden termination of credit is examined, often the borrower was aggrieved by what the borrower views as a *misrepresentation* of the bank's intent, but not by a definite offer to the borrower.

39. Knittel v. Security State Bank, 593 P.2d 92, 95 (Okla. 1979).

40. Okla. Stat. Ann. tit. 15, § 237 (West 1966).

41. *Knittel*, 593 P.2d at 96 (quoting Williamson v. Wanless, 545 P.2d 1145, 1147 (Utah 1976)).

also to statements whereby the lender consents to postpone the due date of the note. If a borrower, reasonably relying on these statements, fails to refinance elsewhere, the lender should be estopped from asserting the loan is due.[42]

Once it is determined that the issue is one of waiver or estoppel, the court must be careful to examine whether, in fact, the lender took actions to induce a borrower to believe credit would be extended or a default waived and whether the borrower was reasonable in relying on such belief.[43] Mere discussions of an extension of credit or even past renewals of credit should not lead a borrower to reasonably believe that credit be will extended or renewed again and again. At most, the reasonable borrower would be led to believe that credit will not be terminated without reasonable notice. To justify the borrower's reliance, the statements should be sufficiently definite to lead the borrower to believe that a binding commitment has been made.

An example of the proper application of the doctrine of equitable estoppel is the Kansas case of *First Bank of Wakeeney v. Moden*.[44] In this case, the bank had renewed credit a number of times. The borrowers alleged that at the time the loan was last renewed, they gave the bank a "farm plan" detailing anticipated operations. The borrowers argued that the bank was obligated to continue extending credit because they successfully operated within the farm plan. The court rejected their contention that the lender was estopped from foreclosing. The court held that the borrowers failed to show any misrepresentation (receiving the farm plan was not tantamount to a representation that the loan would be extended if it was carried out) or reliance on a representation (borrowers were not induced to believe that, regardless of their ability to pay, the loan would be extended if the farm plan was carried out).[45]

4. *Issues of Loan Officer's Authority*

If a borrower is successful in demonstrating that an officer or employee of the lender entered into an agreement to extend credit, there is an issue as to whether that agreement is binding on the bank. This issue is particularly difficult when the employee or officer did not have actual authority to bind a bank because either approval of a loan committee or senior bank official was needed. In

42. *See* the analysis in Becker v. Becker, 250 Ill. 177, 95 N.E. 70 (1911).
43. *See* Iola State Bank v. Biggs, 233 Kan. 450, 662 P.2d 563 (1983).
44. 235 Kan. 260, 681 P.2d 11 (1984).
45. *Id.* at 264-65, 681 P.2d at 14-15.

the absence of actual authority, the issue is whether the officer is able to bind the lender to a contract with the borrower by virtue of an officer's apparent authority. In order for the officer to have apparent authority to bind the lender, the lender must (a) conduct itself in a way that leads the borrower to believe that officer has authority to bind the lender and (b) the borrower's belief must be reasonable.[46] In most cases when a bank appoints an individual to the position of loan officer, the bank's actions imply that the individual so appointed has all of the authority which loan officers customarily have. The more difficult issue is whether it is reasonable for the customer to believe that the loan officer has the authority to make loan commitments without approval.[47] It would be well to look at the business customs of the community in each case. In rural communities, it is not uncommon for some bank officers (who may be owner of the bank) to have sufficient status with any loan committee that it is reasonable for the borrower to believe that the decision of the officer will be the decision of the loan committee. With larger banks, especially when the customer has a history of dealing with the bank, it may not be reasonable to expect the loan officer to have authority to commit to a loan, without approval of others.[48]

B. *Fraud Theories*

All jurisdictions recognize that if a bank commits a fraud against a borrower, the bank is liable for the borrower's damages and, in certain cases, for punitive damages also. Courts disagree, however, as to what constitutes fraud by a lender. This section examines the major categories of fraud asserted by borrowers against lenders. When fraud is discussed in this article, most of the discussion will involve the tort action for deceit or misrepresentation. While contract law provides that contracts may be voided because

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46. Restatement (Second) of Agency § 27 (1958). *See* Bank of N.C. v. Rock Island Bank, 630 F.2d 1243, 1251-52 (7th Cir. 1980); Kraus v. Treasure Belt Mining Co., 146 Mont. 432, 435, 408 P.2d 151, 152 (1965). For a good discussion of a bank officer's apparent authority to commit to a loan, *see* Banker's Trust Co. v. Steenburn, 95 Misc. 2d 967, ___, 409 N.Y.S.2d 51, 67 (N.Y. Sup. Ct. 1978).

47. The promise to extend additional credit or extend the due date of the note is different from a promise to forgive all as part of the debt. Several cases have held that a bank officer does not have the authority to release debtors from their obligations. *See* Rogers v. First State Bank, 79 Colo. 84, 243 P. 637 (1926); Central Republic Trust Co. v. Evans, 378 Ill. 58, 37 N.E.2d 745 (1941); Mt. Vernon Trust Co. v. Bergoff, 272 N.Y. 192, 5 N.E.2d 196 (1936). The rationale behind these cases is that agreement to forgive debt would operate as a fraud on depositors and regulatory authorities. The agreement to extend due date, however, is a much less drastic step and would not rise to that level of fraud.

48. *See Banker's Trust Co.*, 95 Misc. 2d at ___, 409 N.Y.S.2d at 67.

of fraud or misrepresentation, tort fraud is most often asserted because the borrower is not seeking to void the transaction and is not seeking restitution,[49] but is seeking damages as a result of the termination of credit. Borrowers who have lost the farm as a result of the lender's fraud will be less interested in restitution (which focuses on what the lender gained) than in tort damages.[50]

1. *Garden Variety Fraud*

Courts have little difficulty holding lenders liable for terminating credit if the termination of credit involves some type of "garden variety fraud." For the purpose of this article, garden variety frauds are fraud where there is clear evidence that a bank made misrepresentations or took action which violated the law in order to gain an advantage over the borrower. These cases usually involve malice, willful action, oppression or other aggravating circumstances. Cases involving fraud typically fall into several categories:

(1) offsetting a deposit account against a loan where the offset is not permitted by law;[51]

(2) physically altering the terms of a promissory note or other lending documents;[52]

(3) threats of foreclosure, when the lender has no right to

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49. J. CALAMARI & J. PERILLO, THE LAW OF CONTRACTS § 9-13 at 277-78 (1977).

50. W. PROSSER AND W. KEETON, THE LAW OF TORTS § 94 at 673 (1984).

51. A good example of this type of fraud was discussed in Rainsville Bank v. Willingham, 485 So. 2d 319 (Ala. 1986). In this case the Supreme Court of Alabama sustained a punitive damage award because the bank acted "willfully or maliciously." *Id.* at 324.

Not all deposits of borrowers are immune from the bank's power to offset. In Northwestern Bank v. Coppedge, ___ Mont. ___, 713 P.2d 523 (1986), the Montana Supreme Court held that a bank had the right to offset money held at a bank against the amount of a note due to the bank. The offset was permitted by the terms of the promissory note and the money held at the bank was derived directly from the sale of cattle on which the bank had a security interest. An older case, Security State Bank v. First Nat'l Bank, 78 Mont. 389, 254 P. 417 (1927) held that "it is well settled that money deposited in a bank to the credit of one of its debtors, without an express agreement to the contrary or a direction to apply it to a specific purpose, the bank may apply the deposit to the satisfaction of a past due indebtedness." *Id.* at 392, 254 P. at 418. Other jurisdictions have also adopted the rule that a bank may not offset against deposit made for a special purpose. *See* First City Nat'l Bank v. Long-Lewis Hardware Co., 363 So. 2d 770 (Ala. 1978). It should also be noted that many jurisdictions, including Montana, provide that bankers possess banker's liens. In Montana, MONT. CODE ANN. § 71-3-1502 (1985) provides: "a banker has a general lien, dependent on possession, upon all property in his hands belonging to the customer, for the balance due to him from such customer in the course of the business." Although there are no reported Montana cases interpreting this statute, courts in other jurisdictions have limited the bank's ability to offset the indebtedness secured by the banker's lien against any deposit. *See, e.g.*, Bonhiver v. State Bank, 29 Ill. App. 3d 794, 331 N.E.2d 390 (1975).

52. *See* First Am. Nat'l Bank v. Mitchell, 359 So. 2d 1376 (Miss. 1978) (bank officer altered the due date on the note).

foreclosure;[53] or,

(4) false promises that loans would not be called and that further loans would be made if officers and director resigned.[54]

Lenders are not always liable for all wrongful acts committed by their officers or employees. As a general rule bank liability is limited to officers' or employees' acts committed "within the scope of his authority."[55] Courts have had difficulty in determining when acts constituting fraud are within the scope of the officer's authority. Lenders usually argue that it is not within the authority of the officer to take actions which intentionally injure customers. Borrowers argue that it is within the authority of the officer or employee to extend credit, accept deposits, make representations and generally deal with the borrower. If the lender's employee committed a fraud while apparently acting within his authority, the borrowers argue the lender should be responsible. The Restatement (Second) of Agency specifically provides as a general rule that when a principal puts an agent in a position to deceive or commit a fraud upon a third person, the principal is liable for the fraud.[56] The fact that the employee acts for his own purposes does not relieve the bank from liability unless its customer knows that the employee is acting for its own purposes.[57]

Bank customers have been successful in recovering from banks when the connection between the bank's regular course of business and the officer's actions, at first blush, appears quite remote.[58] The willingness of courts to hold banks liable for the actions of their employees, even if the actions amount to fraud, seems reasonable. Banks are better able than bank customers to evaluate employee honesty, promulgate and enforce systems and rules to encourage employee honesty, and identify and terminate employees who are dishonest.

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53. Rutherford v. Rideout Bank, 11 Cal. 2d 479, 80 P.2d 978 (1938). State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984) (false threat that a default would be declared unless management was changed).

54. Stirling v. Chemical Bank, 382 F. Supp. 1146, 1153 (S.D.N.Y. 1974).

55. The factors which courts typically examine to determine whether actions are within the scope of a person's employment are described at RESTATEMENT (SECOND) OF AGENCY § 229 (1958).

56. RESTATEMENT (SECOND) OF AGENCY § 261 (1958).

57. *Id.* at § 262.

58. *See* Rutherford v. Rideout Bank, 11 Cal. 2d 479, 80 P.2d 978 (1938) (borrower sold ranch at request of bank officer for a below market value price; bank officer had been bribed by purchaser); First Am. Bank v. Mitchell, 359 So. 2d 1376 (Miss. 1978) (bank officer altered note); Grenada Bank v. Moore, 131 Miss. 339, 95 So. 449 (1923) (bank officer used customer's bonds as security for his own loan).

2. *Misrepresentation of Intention to Renew Note or Extend Additional Credit*

Clear, garden variety fraud is not common in lawsuits involving termination of credit. More common are allegations that the lender made statements to the borrower that credit would be extended and that these statements amounted to actionable misrepresentations. The borrower alleges that he or she was justified in relying on these statements and that the bank's subsequent failure to extend credit amounted to fraud pursuant to a theory of misrepresentation. According to the Restatement (Second) of Torts, the following elements are necessary for a finding of misrepresentation: "One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused by his justifiable reliance upon the misrepresentation."[59] Hence, the issue of whether the lender has made a tortious misrepresentation involves three primary questions: (1) Was there a misrepresentation? (2) Did the conditions make the misrepresentation fraudulent? (3) Was the borrower justified in relying on the misrepresentation?

The representations made by the lender that lead the borrower to believe that credit may be extended must be examined carefully. A statement that "we will renew your loan" differs from the statement that "it is our current thinking that we will renew your loan." One statement is a representation of fact, while the other is a representation of intention. A lender that represents its intention accurately, but later changes its mind, should not necessarily be liable for a tortious misrepresentation.[60] In negotiations, it is common to make tentative statements of intention which are premised on facts which may or may not be true. For example, if it appears that the farmer may be eligible for a government subsidy program the lender may state that the loan might be extended. Further research, however, may show that the subsidy program is not as favorable as first expected. So long as it is clear that the lender is making statements of its current intent and a reasonable borrower would recognize that the intent is tentative, the lenders should not be found to have made a misrepresentation.[61]

Lenders are not absolutely liable for their misrepresentations. Misrepresentations only result in lender liability if the statements

59. RESTATEMENT (SECOND) OF TORTS § 525 (1977).
60. *Id.* at § 530.
61. *Id.*

are fraudulent.[62] The requirement that representations be fraudulent is known as the scienter requirement. Statements are considered fraudulent, according to the comments to the Restatement (Second) of Torts, if the individual making the statement knows that the representation he makes is "merely a belief" and recognizes that there is a chance, more or less great, that the fact may not be as it is represented.[63] Thus, if a bank officer, knowing that the loan might not be made, reassures the borrower that a loan *will* be made, there will be sufficient evidence of scienter.

Lenders often state that they "probably" will extend credit or they "think" or "believe" that credit will be renewed if the borrower fulfills certain conditions. A lender should be liable to a borrower when these statements are made if a lender has no basis for them. For example, if a bank officer states, "I think credit will be renewed if your operation is profitable," a borrower might reasonably believe that no facts are known to the lender which are incompatible with the statements made, and the lender is aware of sufficient facts to allow him to form the opinion stated. If the lender knows of incompatible facts or has no basis for the statement, the lender ought to be liable for the misrepresentation.[64] Finally, the borrower should be required to demonstrate that he or she justifiably relied on the misrepresentation.[65]

One of the issues which frequently arises in the context of a lender severing credit is the issue of whether the borrower could properly rely on the bank officers who assured them credit would be renewed. For example, assume a borrower knows that decisions to extend credit must be made with the approval of a loan committee, but a loan officer, nonetheless, makes an assurance that the loan will be renewed. A Missouri Court of Appeals faced with this very issue held that where a loan officer's authority to renew loans is limited and the borrower knows it, the borrower cannot complain of an actionable misrepresentation.[66] The court further found that where one borrower misled the other borrower about the extent of the bank officer's authority, the other borrower could not

62. *Id.* at § 526 which states:

A misrepresentation is fraudulent if the maker

(a) knows or believes that the matter is not as he represents it to be,

(b) does not have the confidence in the accuracy of his representation that he states or implies, or

(c) knows that he does not have the basis for his representation that he states or implies.

63. *Id.* at § 526 comment e.

64. *See id.* at § 539.

65. *Id.* at § 537.

66. Centerre Bank v. Distributors, Inc., 705 S.W.2d 42 (Mo. Ct. App. 1985).

complain of the officer's misrepresentation.[67]

It has long been recognized that statements certain business persons make to their customers should be discounted by the customers, because the customers should be aware that the interest of the business persons is to sell the product.[68] Often it is said the customer should realize the business person is merely "puffing" about his or her product and that reliance on "puffing" is not justified. While courts properly hold that a party should not place as much reliance on statements of a person with an adverse interest, this general rule should not apply to the lender-farmer relationship. Lenders generally have fostered the image of being a friend and a business adviser to farmers and should not be viewed as adverse parties.[69]

When examining whether the lender misrepresented the intention to extend credit, courts, then, must carefully analyze whether a representation to that effect has, in fact, been made. As discussed, statements of intention or belief should be treated differently than firm representations.

3. *Misrepresentation of Terms of Loan Documents*

Another issue which arises when a lender terminates credit is whether the lender misrepresented the terms of the note and other lending documents to the borrower. In contrast to the tort misrepresention theory of fraud previously described, a borrower or guarantor who prevails in the theories examined in this section is usually entitled to avoid a provision of the contract or entitled to restitution. Claims that the lender did not adequately disclose or explain the provisions of the loan usually arise when the lender has an unequivocal right, according to the contract, to foreclose or sever credit. Examples of these claims are:

> (1) the lender failed to explain properly exactly which documents the customers are signing;[70] and
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> (2) the lender failed to explain to the customer the risk involved with the documents signed by a borrower or guarantor.[71]

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67. *Id.* at 49-50.

68. RESTATEMENT (SECOND) OF TORTS § 539 comment c (1977).

69. *See infra* note 77.

70. Northwestern Bank v. Roseman, 81 N.C. App. 228, 344 S.E.2d 120, *disc. rev. denied*, 318 N.C. 284, 348 S.E.2d 139 (1986). In *Roseman*, a bank customer expressly stated that he did not want to sign a guarantee but the bank included a guarantee in the packet of documents.

71. Kurth v. Van Horn, 380 N.W.2d 693 (Iowa 1986). In this case the bank made its file available to the elderly guarantor prior to the execution of the guarantee and insisted in meeting with the guarantor outside of the presence of the borrower. Because the decision to

In the context of the termination of credit, two issues typically arise. The first issue is whether the lender owes a fiduciary duty to the borrower which results in a duty to disclose matters not otherwise required to be disclosed. The second issue involves the question of how much the lender is expected to explain to the borrower about the notes.[72]

a. *Fiduciary Duty*

When attempting to argue that lenders have a duty to disclose or explain certain matters, borrowers frequently encounter the argument that the lender had no duty to disclose voluntarily certain information. To overcome that burden, borrowers often argue that their relationship with the lender is that of a fiduciary. To establish the case that the lender is a fiduciary, borrowers argue that the lender was a business adviser. In the farm situation, borrowers sometimes argue that because they were advised to expand their business, use certain production materials, or plant certain crops, the lender acted as a fiduciary.

As a general rule, courts have held that the relationship between a bank and borrower is not a fiduciary relationship.[73] The Montana Supreme Court held:

> As a general rule, the relationship between a bank and a depositor or customer does not ordinarily impose a fiduciary duty of disclosure upon the bank. They deal at arms length [citation omitted]. However, special circumstances may dictate otherwise. One who speaks must say enough to prevent his words from misleading the other party; one who has special knowledge of material facts to which the other party does not have access may have a duty to disclose these facts to the other party; and one who stands in a confidential or fiduciary relation to the other party to a transaction must disclose other facts.[74]

A fiduciary relationship between a lender and borrower may be established when a borrower demonstrates that a lender acted as financial adviser to a subservient borrower and the borrower relied on the lender's advice.[75] Factors a court considers when deter-

execute the guarantee was that of guarantor the bank was not liable.

72. The distinction between these issues was discussed in Central Nat'l Bank v. Shoup, 501 N.E.2d 1090, 1093 (Ind. Ct. App. 1986).

73. Kurth v. Van Horn, 380 N.W.2d 693, 696 (Iowa 1986); Manson State Bank v. Tripp, 248 N.W.2d 105, 108 (Iowa 1970); Deist v. Wachholz, ___ Mont. ___, ___, 678 P.2d 188, 193 (1984).

74. Deist v. Wachholz, ___ Mont. ___, ___, 678 P.2d 188, 193 (1984).

75. *Id.* In the *Deist* case the bank advised a rancher and his wife for 24 years. After the rancher died, the bank continued to render the advice. As a result the bank was consid-

mining whether borrowers are subservient generally include the borrower's age, mental capacity, health, education and degree of business experience. The courts also focus on the degree to which the subservient party entrusted his or her affairs to the lender and reposed confidence in the lender.[76]

The amount of advice given by lenders to farmers varies. Many agricultural lenders seek to develop a reputation that they know the farm business. Farmers and bank officers, particularly in small towns, develop close personal relationships to their borrowers that are mutually beneficial. For example, farmers look to bankers for their views on type of crops to plant, the expected trend in prices and the desirability of expanding or contracting operations.[77] Even those lenders which do not discuss various aspects of the farm business with their customers usually have some involvement in their customer's business. Banks, as a condition of making or renewing loans, frequently restrict the operation of the business and, at times, may require partial liquidations of the business.

So long as the farmer makes his or her own business decisions and the advice given by the lender is nothing more than optional advice or is reasonably related to protection of the lender's interest in its collateral, lenders should not be treated as having a fiduciary responsibility to the borrower. Debtors should not be allowed to rely blindly on advice given by a lender and hold the lender responsible for its losses if the advice, with the benefit of hindsight, is not appropriate. To so hold would discourage borrowers from exercising ordinary prudence in relying on the business advice given by others.[78] As aptly stated by the North Carolina Court of Appeals: "Courts must cautiously balance the conflicting policies of suppressing fraud on one hand and discouraging neglect and inat-

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ered a fiduciary.

76. Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 64 P.2d 101 (1937); Fridenmaker v. Valley Nat'l Bank, 23 Ariz. App. 565, 534 P.2d 1064 (1975); Farmer City State Bank v. Guingrich, 139 Ill. App. 3d 416, 424, 487 N.E.2d 758, 763 (1985); Denison State Bank v. Madeira, 230 Kan. 684, 640 P.2d 1235 (1982); Pigg v. Robertson, 549 S.W.2d 597 (Mo. Ct. App. 1977). *See also* RESTATEMENT (SECOND) OF TORTS § 874 comment a, at 300 (1979).

77. According to a survey completed by the National Federation of Independent Businesses conducted in 1982, 95% of small businesses believe that it is important or very important for their bank to give helpful business suggestions. The survey concludes that 80% of small businesses believe their bank is above average or good at giving helpful suggestions. Likewise, 55% of the borrowers believe it is important or very important that the bank know the borrower and the borrower's business. Dunkelberg, *Small Business and the Value of the Bank-Customer Relationship*, 14 J. BANK RES. 251, 253 (1984).

78. Currently the law requires that ordinary prudence be used when relying on business associates. Johnson v. Lockman, 41 N.C. App. 54, 58, 254 S.E.2d 187, 189, *disc. rev. denied*, 297 N.C. 610, 257 S.E.2d 436 (1979).

tention toward one's obligations on the other."[79] Farmers and other small business owners are ultimately in the best position to make decisions regarding their businesses. The mere fact that erroneous advice was given by the bank should not result in bank liability, because it is the farmer that ultimately makes the decision. Further, occasional advice given by the bank should not be the basis for a claim of fiduciary duty. Before holding banks liable as fiduciaries, courts should examine whether advice was given to a subservient borrower over a period of time.[80]

Lenders, under certain circumstances, require borrowers to comply with loan covenants restricting the operation of the borrower's business. The borrower's consent to these covenants is often a condition of obtaining a loan or renewal of credit. Conditions precedent to obtaining a loan may include agreements to operate within a specific business plan, liquidate part of the farm or ranch, or sell some of the equipment. If these conditions are not fulfilled, the loan will not be extended. Likewise, lenders require borrowers to make certain covenants concerning the operation of their business. Usually the lender may declare a default and accelerate the due date of the loan if these covenants are breached. These covenants often include promises to maintain the collateral and promises to obtain lender approval of certain transactions. These covenants may serve to keep a "leash" on the operations of the borrower.[81] Arrangements such as these should not give rise to the creation of a fiduciary duty so long as the lender's restraints are reasonably necessary to protect its interest in the collateral and are made in good faith.[82]

Once a fiduciary relationship is established, the lender must not only refrain from concealing information and making misleading statements, but also must disclose facts which may reasonably affect the judgment of the borrower.[83] As most aptly stated by the Arizona Supreme Court, once a fiduciary relationship is estab-

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79. *Northwestern Bank*, 81 N.C. App. at 234, 344 S.E.2d at 124.

80. *Compare Deist*, ___ Mont. ___, 678 P.2d 188 *with* Pulse v. North Am. Land Title Co., ___ Mont. ___, 707 P.2d 1105 (1985). In *Deist*, where a fiduciary relationship was found, the bank dealt with the plaintiff and her late husband for 24 years. In *Pulse*, where no fiduciary relationship was found, the plaintiff had only dealt with the loan department of the bank on a "few" occasions. *Pulse*, ___ Mont. at ___, 707 P.2d at 1110.

81. *See* R. Nassberg, The Lender's Handbook 16 (1986).

82. Wagner v. Benson, 101 Cal. App. 3d 27, 35, 161 Cal. Rptr. 516, 521 (1980) ("Normal supervision of the enterprise by the lender for the protection of its security interest in loan collateral is not 'active participation'.")

83. *Diest*, ___ Mont. at ___, 678 P.2d at 195. Other courts have held that *material* facts must be disclosed. Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 44, 64 P.2d 101, 106 (1937).

lished, "the party in whom confidence is thus reposed must 'lay his cards on the table'."[84]

b. *Duty to Review Documents*

Borrowers sometimes allege that even if a lender does not stand in a fiduciary relationship with the borrower, it has a duty to disclose and describe certain conditions or covenants in the loan documents or risks inherent in the loan transaction. The typical claim is that the borrower signed a stack of papers at closing, did not read the papers, and was misled as to their content.[85]

The two important cases that discuss this claim are *Farmer City State Bank v. Guingrich*[86] and *Kurth v. Van Horn*.[87] In *Farmer City State Bank*, the borrower made the specific statement that he did not desire to sign an unlimited guarantee which would guarantee all of the borrower's debt, but would only sign a limited guarantee of a specific debt. At closing, the guarantor signed an unlimited guarantee. The guarantor admitted that he did not read the documents he signed and the bank officer admitted that he did not inform the guarantor of his obligations under the guarantees. The court refused to reform the guarantees because the law presumes that the written instrument describes the intent of the parties, and the evidence was not sufficient to overcome that presumption.[88] The court also rejected the guarantor's contention that it stood in a fiduciary relationship with the bank.[89] The court held that the guarantor had, however, alleged sufficient facts to set forth a claim for fraud by alleging that the bank falsely and fraudulently represented that guarantees signed by other directors would protect the original guarantor. The court rejected the bank's defense that the guarantor could have avoided his loss if he would have read the documents. The court stated that "actions or statements of the person making a misrepresentation may inhibit the other person's inquiries or lull him into a false sense of security, thereby blocking investigation into the truth of the representation."[90] The court concluded that there was a *false* representation

84. *Stewart*, 49 Ariz. at 44, 64 P.2d at 106.

85. *See, e.g.*, Central Nat'l Bank v. Shoup, 501 N.E.2d 1090 (Ind. Ct. App. 1986) (failure to disclose a due on sale clause and a prepayment penalty clause, when the bank knew it was borrower's intention to sell the collateral).

86. 139 Ill. App. 3d 416, 487 N.E.2d 758 (1985).

87. 380 N.W.2d 693 (Iowa 1986).

88. 139 Ill. App. 3d at 421-22, 487 N.E.2d at 762.

89. *Id.* at ____, 487 N.E.2d at 763 (rejecting *Stewart*, 49 Ariz. 34, 64 P.2d 101, which was cited by the Montana Supreme Court with approval in *Diest*).

90. *Id.* at ____, 487 N.E.2d at 765.

made by an experienced bank to an inexperienced person and, as a result, the bank was liable for fraud.[91]

Contrast the *Farmer City State Bank* case to the *Kurth* case. In both cases, allegations were made that the bank officer failed to explain adequately the consequence of cosigning or guaranteeing a note. In *Kurth*, a customer who borrowed from the bank pressured his neighbor, Herman Gerdes, to cosign his bank debt. The borrower pressured Gerdes because the bank threatened a foreclosure as a result of the borrower's financial difficulties. The bank stood to benefit from having a cosigner because without the cosigner the bank might have lost a Farmers Home Administration (FmHA) guarantee and might have lost an opportunity to receive the proceeds of a Small Business Administration loan which would have been used to reduce the amount of the loan due to the bank. The cosigner alleged that the bank did not make him aware of these facts. The cosigner was forced to make good on the note and sued the bank alleging that he relied on the bank officer to render advice on the contents of the documents he signed or, in the alternative, the bank failed to advise him to obtain an attorney.[92] The court rejected the cosignor's allegation that the bank was a fiduciary and upheld the jury finding that there was no fraud. To require a cosignor to retain an attorney before he does what he clearly wants to do is a "form of protectionism [that] goes far beyond the exercise of the banker's responsibilities. . . . The bank had no affirmative duty to prevent Gerdes from doing what the evidence clearly shows he wanted to do."[93]

The critical difference between its two cases was that, in *Farmer City State Bank*, reassuring statements were made to lull the guarantor into a sense of security while, in *Kurth*, no such statements were made. Generally, failure to read the terms of a contract is not sufficient reason to justify rescission of the contract because of the presumption that the written contract states the agreement of the parties.[94] Likewise the farmer should not be able to avoid a contract and seek restitution or tort damages on a fraud

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91. *Id.* A similar result was reached relying on similar facts in Marine Bank, N.A. v. Meat Counter, Inc., 635 F. Supp. 1029 (N.D. Ill. 1986).

92. *Kurth*, 380 N.W.2d at 696-97.

93. *Id.* at 697.

94. *See also* Merit Music Serv. Inc. v. Sonneborn, 245 Md. 213, 221-222, 225 A.2d 470, 474 (1967) ("the law presumes that a person knows the contents of a document that he executes and understands at least the literal meaning of its terms"); Nat'l Bank v. Equity Inv., 81 Wash. 2d 886, 912-13, 506 P.2d 20, 36 (1973) ("The whole panoply of contract law rests on the principle that one is bound by the contract which he voluntarily and knowingly signs.")

theory due to the lender's lack of explanation of the terms of the agreement or risks involved. Farmers are business persons and should be treated as such.[95] Lenders should not be responsible for the borrowers' losses in these cases unless they have taken affirmative steps that are calculated to mislead the borrower.

4. *Constructive Fraud/Negligent Misrepresentation*

One of the most difficult elements of fraud to prove is the element of fraudulent intent. It is particularly difficult for a borrower to prove which statements the lender's employees knew were not true or if the employees did not have sufficient information to justify their statements. As a result, some creditors rely on theories of constructive fraud when attempting to recover against a lender when the lender terminates credit. Constructive fraud consists of a breach of a duty by misleading another to the prejudice of the other and to the benefit of the person with the duty.[96] A showing of fraudulent intent is not required.[97] While the theory of constructive fraud is generally asserted in a contract action to avoid a contract,[98] it has also been asserted to support a claim for tort damages.[99]

One of the leading cases is *Hunt v. McIlroy Bank and Trust.*[100] In *Hunt*, the farmers negotiated financing to expand their farms. The terms of long-term financing were never finalized, but short-term notes, mortgages and other documents were executed so

95. Farmers should not be treated any differently from an "80 year old spinster" who never engaged in any business activity and who did not read a mineral deed before signing it. In holding the woman to the terms of the deed the court said, "Neither inexperience nor inferior knowledge will excuse plaintiff from reading the deed . . . nor in failing to secure outside advice." Clough v. Jackson, 156 Mont. 272, 286, 479 P.2d 266, 274 (1971).

96. MONT. CODE ANN. § 28-2-406 (1985). *See also* McGregor v. Mommer, ___ Mont. ___, ___, 714 P.2d 536, 543 (1986); Mends v. Dykstra, 195 Mont. 440, 637 P.2d 502 (1981); Moschelle v. Hulse, ___ Mont. ___, ___, 622 P.2d 155, 159 (1980). Although courts often find constructive fraud in conjunction with the finding of a fiduciary relationship, the finding of a fiduciary relationship is not a prerequisite to a finding of constructive fraud. *McGregor*, ___ Mont. at ___, 714 P.2d at 543. The theory of constructive fraud has been applied in a case involving a "very close" relationship between a bank and personal guarantors of a loan. 178 Cal. App. 3d 960, 224 Cal. Rptr. 76 (1986).

97. MONT. CODE ANN. § 28-2-406 (1985).

98. J. CALAMARI & J. PERILLO, *supra* note 48, §§ 9-13 at 277-78.

99. The theory of constructive fraud has apparently been used in Montana outside the area of contract damages. *See* Farmers State Bank v. Imperial Cattle Co., ___ Mont. ___, 708 P.2d 223 (1985). More properly, the courts should analyze these cases in terms of negligent misrepresentation, although the elements of constructive fraud and negligent misrepresentation are simple. Both involve some sort of undertaking or duty and both do not require fraudulent intent. *See supra* text accompanying notes 106-12.

100. 2 Ark. App. 88. 616 S.W.2d 759 (1981).

expansion could immediately begin.[101] The farmers' theory was that short-term financing would not have been accepted, if they had not been misled by the bank that long-term financing would be provided. In rejecting the farmers' argument, the court found that there was no evidence that the lender made any untrue statement.[102] Although the court found the farmers believed more funds and long-term financing were forthcoming, the bank acted in good faith by "attempting to work with" the borrowers.[103] The bank was not liable because it did not intentionally mislead the borrower—the Federal Reserve Board had reclassified the loan because of declining value of the collateral.[104] The *Hunt* case is significant because it approved of the bank changing its willingness to extend credit to the borrower because the declining value of the security was not anticipated at the time of the loan and it approved of a reclassification of the loan and termination of the credit notwithstanding evidence of discussions of permanent financing.[105]

Although the concept of constructive fraud is usually used as a defense to a contract action, it is also proper to find constructive fraud in the tort sense when there is no proof of an intent to deceive. Virtually all courts recognize that negligent, but not fraudulent, misrepresentation may provide a basis of liability when the parties have a pre-existing relationship or where the nature of the representative's relationship creates a special duty.[106] For example, several courts have held that when a bank seeks to give advice to a customer about the creditworthiness of another borrower, it will be liable if incorrect advice is negligently given.[107] These courts reason that because the bank is rendering a service to someone with which it has a relationship, there is a special duty to render the service with care. The holding in these cases is consistent with section 552 of the Restatement (Second) of Torts, which states:

> One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary

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101. *Id.* at 90, 616 S.W.2d at 761.
102. *Id.* at 92, 616 S.W.2d at 762.
103. *Id.*
104. *Id.*
105. *Id.*
106. W. Prosser and W. Keeton, The Law of Torts § 107 at 746 (1984). *See also* Crystal Springs Trout Co. v. First State Bank, ___ Mont. ___, 732 P.2d 819 (1987); Northwestern Nat'l Bank v. Weaver-Maxwell, Inc., ___ Mont. ___, 729 P.2d 1258 (1986).
107. Bank of Nevada v. Butler Aviation-O'Hare, Inc., 96 Nev. 763, 765, 616 P.2d 398, 399 (1980); First City Bank v. Global Auctioneers, Inc., 708 S.W.2d 12 (Tex. Ct. App. 1986).

> interest, supplies false information for the guidance of others in their business transactions, is subject to liabilities for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in defining or communicating the information.[108]

The typical lender ought to be responsible for his or her negligent misrepresentation to borrowers because the typical lender makes these statements in the course of its business with the borrowers. Borrowers are entitled to expect that bank officers who make statements that a loan will probably be renewed will use ordinary care and competence when making those statements.[109]

The Montana Supreme Court applied the doctrine of negligent misrepresentation to the termination of credit in *State Bank of Townsend v. Maryann's, Inc.*[110] In this case the bank officer inserted a $50,000 borrowing limit in a bank customer's corporate borrowing resolution. Within the next five months, the bank extended credit in the amount of $29,000. The customer desired to obtain an additional $17,000 loan to exercise an option under a lease agreement. The bank refused to make the loan and the lease option was rescinded by the lessor. Shortly thereafter the bank declared the customer's notes due and sued to collect the amount due. The customer filed a counterclaim alleging that the bank had represented that a $50,000 line of credit would be available. Based on testimony that the bank inserted $50,000 in the borrowing resolution, the court found that the evidence appeared sufficient to support the finding of negligent misrepresentation. The Montana Supreme Court remanded the case to the district court because of error in the jury instructions and special interrogatories, with instructions that the bank's conduct be tested against Restatement (Second) of Torts section 552. The court specifically noted, by quoting the comments to the Restatement, that one who makes a negligent representation will be responsible for that representation only if "the maker was manifestly aware of the use to which the information was to be put and intended to supply it for that

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108. RESTATEMENT (SECOND) OF TORTS § 552(1) (1977). This provision of the Restatement has been quoted with approval by the Montana Supreme Court in State Bank v. Maryann's, Inc., ___ Mont. ___, ___, 664 P.2d 295, 301 (1983), and Brown v. Merrill Lynch, Pierce, Fenner & Smith, Inc., ___ Mont. ___, ___, 640 P.2d 453, 458-59 (1982).

109. One court found that because the banking business is affected with the public interest, banks must use reasonable care in dealing with their customers. The court held that this duty of care included a duty against negligent misrepresentations. Hill v. Equitable Bank, 655 F. Supp. 631, 650-51 (D. Del. 1987).

110. ___ Mont. ___, 664 P.2d 295 (1983). *See also* Crystal Springs Trout Co. v. First State Bank, ___ Mont. ___, 732 P.2d 819 (1987).

purpose."[111]

Negligent misrepresentation should not serve to hold lenders responsible for their predictions as to how much credit may be extended in the future, when all parties are aware that the lenders' statements are merely predictions and not intended to be relied on.[112]

5. *Economic Duress*

Another argument asserted by borrowers that is closely related to fraud is the tort of economic duress. The tort of economic duress should be distinguished from defense of duress to a contract action. Duress in contract actions merely avoids the contract and serves as a basis for a claim of restitution, while the tort of economic duress may result in tort damages.[113] The elements of the tort of duress are:

> [1] [T]here is a threat to do an act the threatening party has no legal right to do [2] [The threat] must . . . destroy the free agency of the party against whom it is directed . . . . [3] The restraint caused by such threat must be imminent [4] It must be such that the person to whom it is directed has no present means of protection.[114]

Although the Montana Supreme Court is not sympathetic to claims of economic duress,[115] a recent Texas case should encourage attorneys representing borrowers about the viability of the action when asserted against banks. In *State National Bank of El Paso v. Farah Manufacturing Co., Inc.*,[116] a Texas Court of Appeals upheld an $18 million judgment against the State National Bank, in part on the theory of economic duress. In this case the State Na-

111. *Id.* at ___, 664 P.2d at 302 (quoting RESTATEMENT (SECOND) OF TORTS § 552 comment a at 127-30). For another good discussion of the application of the theory of negligent misrepresentation to termination of credit, see Banker's Trust v. Steenburn, 95 Misc. 2d 967, ___, 407 N.Y.S.2d 51, 66-68 (N.Y. Sup. Ct. 1978).

112. It should be noted, however, that the Supreme Court of Montana has held that "[t]here is a right to rely when parties are not on equal footing and do not have equal means of knowing the truth." Brown v. Merrill Lynch, Pierce, Fenner & Smith, Inc., ___ Mont. ___, ___, 640 P.2d 453, 459 (1982). *See also* Koch v. Rhodes, 57 Mont. 447, 188 P. 933 (1920).

113. *See* State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 683 (Tex. Ct. App. 1984).

114. *Id.*, at 684 (quoting Dale v. Simon, 267 S.W. 467, 470 (Tex. Ct. App. 1924)).

115. Montana cases have dealt with economic duress as a defense in a contract action. *See* Kovash v. Knight, 169 Mont. 227, 545 P.2d 1091 (1976); Double X Ranch, Inc. v. Savage Bros., 167 Mont. 231, 536 P.2d 1176 (1975); McNussen v. Graybeal, 146 Mont. 173, 405 P.2d 447 (1965).

116. 678 S.W.2d 661 (Tex. Ct. App. 1984).

tional Bank was unhappy that William Farah was about to be elected as a director of Farah Manufacturing Co., Inc., instead of a director preferred by the bank. State National Bank warned shareholders that if William was elected, it would consider the election an event of default, which would entitle the bank to accelerate the loan. State National Bank was one of three banks participating in the loan. The banks, by contract, had the right to accelerate the loan if the company's management was changed. The right to accelerate was subject to the provisions of Texas U.C.C. § 1-208 that states that the lender's proposal to accelerate must stem "from a reasonable, good faith belief that its security was about to be impaired."[117] The banks had the contractual right to accelerate, but only when two of the three banks agreed to elect to accelerate. State National Bank, without obtaining the agreement of the other banks, made the threat to accelerate if there was a change of management.[118] Making threats to encourage the borrower to vote to reelect State National Bank designated management constituted duress, for which the injured borrower could receive tort damages.[119]

The success of Farah Manufacturing Company may encourage borrowers' attorneys to take a careful look at the tort of economic duress as a weapon to use against farm lenders when the farm lender tightens up or terminates credit. The tort of duress arises when a bank makes a threat to take adverse action on a loan unless the farmer takes certain actions (e.g., plants specific crops, sells certain assets, changes management), if these threats either are not permitted by the agreement or bear no relationship to preservation of the bank's interest in the collateral. In these cases the rules set forth in *State National Bank* should apply. *State National Bank*, however, should be narrowly construed. If the loan is due, bank demands should not provide a basis for the tort of duress. The application of *State National Bank* should be limited to loans that are not due. When a loan is due the lender is not bound by the good faith requirements of U.C.C. § 1-208.[120] The holding of *State*

117. *Id.* at 685. The language of U.C.C. § 1-208 purports to require the lender to act in good faith when accelerating a loan "at will" or "when [the creditor] deems [it]self insecure or words of similar import." Several federal courts, including the Ninth Circuit, have held that the good faith requirement applies to most events of default. Brown v. Avenco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979) (covenant not to lease the collateral) and Sheppard Federal Credit Union v. Palmer, 408 F.2d 1369 (5th Cir. 1969).

118. *State Nat'l Bank*, 678 S.W.2d at 686.

119. *Id.*

120. U.C.C. § 1-208 by its terms applies only to acceleration or demands for additional collateral.

National Bank is premised on U.C.C. § 1-208. When a note is due, the lender, absent extraordinary circumstances, should be free to use its limited resources to loan its money to the most creditworthy borrower available in order to discharge its obligations to return a maximum profit for the benefit of its shareholders.

Those jurisdictions recognizing the tort of economic duress should apply the standards used when economic duress is asserted in contract actions. Just as courts require a showing of wrongful or unlawful conduct when duress is alleged as a defense to contract actions,[121] courts should apply a similar standard to the tort of duress when dealing with credit problems. Absent use of improper means, lenders must be able to realize and enforce the protections provided for their benefit in the lending instruments. Otherwise, the benefit of the bargain, for the lenders, is destroyed. As the Court in *State National Bank* stated: "[t]hreatening to do that which a party has the legal right to do cannot form the basis of a claim of duress by business compulsion. The vice arises when he employs extortive measures, or when, lacking good faith, he made improper demands."[122] An overbroad application of the tort of duress would effectively deprive the farm lenders from the ability to drive a hard bargain—a step which would be unprecedented.[123]

C. *Interference with Contract*

A less common claim made against lenders is that their failure to extend credit interfered with the borrower's contracts or prospective contractual relations with its other customers or creditors.[124] This theory may be attractive where it is impossible to

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121. McNussen v. Graybeal, 146 Mont. 173, 405 P.2d 447 (1965). Although the Montana Supreme Court has not found sufficient evidence of wrongful conduct in connection loan with contract action defense, the New Mexico Supreme Court has. In the landmark case of Pecos Constr. Co. v. Mortgage Inv. Co., 80 N.M. 680, 459 P.2d 842 (1969), a lender entered into a binding loan commitment with a borrower. When it was time to fund the loan, the borrower unilaterally demanded a higher commitment fee. The court, relying on RESTATEMENT (SECOND) OF CONTRACTS § 492, and finding intentional and wrongful conduct found that '[f]ear of an economic loss is a form of duress; thus, a party is not bound by the contract.'" *Pecos Constr. Co.*, 80 N.M. at 683-84, 459 P.2d at 844-45.

122. *State Nat'l Bank*, 678 S.W.2d at 684.

123. Likewise, 5 S. WILLISTON, CONTRACTS, § 1618 (rev. ed. 1937), recognizes that to broaden the defense of duress in a contract action may preclude a person from driving a hard bargain.

124. The elements of the tort of interference with existing contracts are as follows:

> One who intentionally and improperly interferes with the performance of a contract . . . between another and a third person by inducing or otherwise causing the third person not to perform the contract is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to

prove all of the elements of a contract to extend credit.

The successful application of this theory was best illustrated in *Peterson v. First National Bank.*[125] Peterson did not have sufficient funds to pay the rent due on his farm. Peterson obtained a Commodity Credit Corporation (CCC) loan using crops as collateral. Discussion ensued between Peterson and the bank about the possibility of assigning CCC proceeds to the bank in exchange for a loan to pay the rent. Peterson tendered the past due rent to the landlord, telling the landlord that his check for rent could be deposited when the CCC proceeds were received from the bank. Instead of making the proceeds available to the borrower or landlord, the bank offset the checks against the amount of the debt and refused to lend Peterson the funds to pay the landlord. The landlord terminated the lease of the farm because the rent was not paid.[126]

The issue before the Court was whether the bank interfered with the rental contract. The bank's major defense was that it was privileged or justified to refuse to lend additional monies.[127] Specifically the bank alleged that (a) it had a financial interest in the farmer; (b) it acted with the intention of protecting its interest from being jeopardized; and, (c) it did not employ improper means in doing so. The court, without addressing the first two allegations, stated that there was evidence that the bank did not act with proper means.[128] The court did not specify exactly what improper means were used by the bank, but presumably it was based upon the loan officer's concession that he may have left the *landlord* with "the impression" that the rent would have been paid out of the CCC proceeds.[129] It is difficult to determine why the *landlord's*

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perform the contract.

RESTATEMENT (SECOND) OF TORTS § 766 at 7 (1979). *See also* Northwestern Nat'l Bank v. Weaver-Maxwell, Inc., ____ Mont. ____, 729 P.2d 1258 (1986).

125. 392 N.W.2d 158 (Iowa Ct. App. 1986).

126. *Id.* at 160.

127. Usually, the defense raised by the bank would be applicable only in cases involving *prospective* contractual relations. *See* RESTATEMENT (SECOND) OF TORTS § 769 (1979), which states:

> One who, having a financial interest in the business of a third person intentionally causes that person not to enter into a prospective contractual relation with another does not interfere improperly with the other's relation if he
>
> (a) does not employ wrongful means and
>
> (b) acts to protect his interest from being prejudiced by the relation.

More properly, the bank should have relied on RESTATEMENT (SECOND) OF TORTS § 767 (1979) which describes when an actor may properly interfere with existing contracts. The importance of the defense of justification, when asserted against a bank, was discussed in *Northwestern Nat'l Bank*, ____ Mont. at ____, 729 P.2d at 1262-63.

128. *Peterson*, 392 N.W.2d at 167.

129. *Id.* at 160-61.

impression that he would be paid supports the tenant's claim that a contract was interfered with. Generally, courts should hesitate to find that a failure to extend credit interfered with contracts unless the lender's commitment to extend credit amounts to a fraudulent misrepresentation. If the borrower relies on a misrepresentation for the basis of his claim for tortious interference with contract, the borrower must be able to demonstrate that the lender made a representation knowing it was false, without confidence in its accuracy, or without sufficient basis.[130] Predictions that credit may be extended or statements of intention to extend credit must be scrutinized by the courts in the same way they would be if the claim was one of misrepresentation.[131] Usually mere predictions or statements of intention should not give rise to tort liability for misrepresentation[132] or tortious interference with contract.

D. *Negligence in Processing a Loan Renewal Application*

Some farmers believe that lenders, because of their desire to limit their agricultural lending, superficially review loan applications or requests to extend the due date of the loan, but do not seriously consider them. If a lender undertakes to review a loan application or a renewal application, and the application meets its guidelines, but is rejected nonetheless, is the lender liable on a theory of negligence? It depends upon whether the lender, by taking a loan application, owes a duty to the borrower to review the loan application with care. The existence of this duty depends upon an analysis of considerations of policy as well as "changing social conditions" which entitle plaintiffs to protection.[133] Although there are very few cases which discuss this issue or these considerations, claims based on negligence are on the cutting edge of the law concerning lender liability.

The best discussion of the issue of negligent review of a loan application is the decision of the Court of Appeals of Maryland in *Jacques v. First National Bank.*[134] In *Jacques*, the prospective borrowers, who had a contract to purchase a home, applied for a bank loan. The bank collected a fee for an appraisal and credit check and agreed to "lock in" an interest rate for 90 days. Because

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130. Restatement (Second) of Torts §§ 526, 767 comment c (1979).
131. *Id. See supra* text accompanying notes 59-63.
132. *Id. See supra* text accompanying notes 64-69.
133. W. Prosser & W. Keeton, *supra* note 50, § 53 at 359 (1984).
134. 307 Md. 527, 515 A.2d 756 (Md. Ct. App. 1986). The rationale of the Maryland Court of Appeals was cited with approval in Hill v. Equitable Bank, 655 F. Supp. 631 (D. Del. 1987).

the bank failed to process the application in accordance with its standards, the borrowers received a commitment for a much smaller loan than they desired. Interest rates increased while the loan application was being processed. The borrowers claimed they suffered an economic loss because of the increased interest rate.[135] The court noted that since the damage to the prospective borrower was economic loss only, the court must determine whether there is sufficient "intimate nexus" to justify the creation of a duty to process the loan application with care.[136] The intimate nexus could be established by contractual privity or the equivalent. The court held there was "intimate nexus," because the bank received a fee (albeit the fee was to be paid to third parties for appraisal and credit reports) and locked in an interest rate.[137] Further, the bank would have received a business advantage if the loan were made. The court found that those actions, in effect, enticed the customer to deal with that bank and no other.[138] As a result, the bank had a duty because it "expressly undertook to process the application, advised its customer of the probable time required for processing, guaranteed a specified rate of interest for a period of ninety days . . . and entered upon performance."[139] The court also noted that borrower was committed to purchase real estate and would be required to generate more cash if the maximum loan available from the bank was less than expected.[140] Finally, the court noted that "the banking business is affected with the public interest;" therefore "banks and their officers have been held to a high degree of integrity and responsiveness to their public calling."[141] The court then held that a jury could have found that the bank departed from the applicable standard of care. Among other departures, 1) the loan officer averaged two years of income, instead of the usual three years; 2) certain income from stock was excluded; and, 3) the bank failed to consider that the borrower's past income was lower due to illness.[142]

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135. 307 Md. at 530, 515 A.2d at 757.
136. *Id.* at 534-35, 515 A.2d at 759-60.
137. *Id.* at 537-38, 515 A.2d at 761.
138. *Id.*
139. *Id.* at 539, 515 A.2d at 762.
140. *Id.* at 540-41, 515 A.2d at 762-63.
141. *Id.* at 542, 515 A.2d at 763.
142. *Id.* at 544 n.7, 515 A.2d at 765 n.7. The Maryland decision is subject to criticism. Many of the actions the court found to be bank "errors" are within the bank's normal decision-making analysis. For example, if the customer's income is low because the customer was sick for two years, the bank may properly assume that sickness may reoccur. The bank should not be forced to accept the customer's assurance of his improved health at face value.

The bank argued that a credit decision is a "largely judgmental process of evaluating loan applications [and] defies the imposition of a standard [of care]."[143] The court rejected this analysis because standards of care are set for many defendants, such as physicians, who exercise judgment. The court cautioned, however, that proof that another banker would have made the loan is not sufficient:

> To be successful then, a plaintiff must show more than that another banker would have approved a loan that was refused, or would have found a customer qualified for a different amount. The plaintiff must show that a defendant failed to exercise that degree of care which a reasonably prudent bank would have exercised under the same or similar circumstance.[144]

The duty to process a loan application with care should not extend to all loan applications, but only to those where the lender's actions are sufficient to lead the borrower to reasonably believe that he or she will be treated in accordance with identifiable lender standards. A California Court of Appeals, in *Wagner v. Benson*, correctly held that the general rule is that in approving a loan application, a lender owes no duty of care.[145] In *Jacques*, the court distinguished the undertaking to the bank to lock in an interest rate from a unilateral submission of a loan application.[146]

A duty of the lender to act with care when processing loan applications would presumably apply to agreeing to undertake assisting a borrower to obtain a government backed loan, including a FmHA loan. Although lenders are not obligated to assist their customers in obtaining such loans, once they voluntarily undertake to do so, they must act with care.[147]

In the case of a borrower who is unable to pay the principal or interest on a loan and applies for renewal of the loan, it would seem that the same duty would apply, but only if the lender undertakes to review the application and discourages the borrower from going elsewhere. If the lender undertakes to review the application, then such review must be made in accordance with reasonable

143. *Id.* at 543, 515 A.2d at 764.

144. *Id.* at 543-44, 515 A.2d at 764.

145. 101 Cal. App. 3d 27, 35, 161 Cal. Rptr. 516, 521 (1980) (bank was not negligent in failing to inform borrowers that the borrowers were about to invest the loan proceeds in a risky venture).

146. *Jacques*, 307 Md. at 538-39, 515 A.2d at 762. *See also* John Deere & Co. v. Short, 378 S.W.2d 496, 502-03 (Mo. 1964); Farabee Treadwell Co. v. Union & Planters' Bank & Trust, 135 Tenn. 208, 186 S.W. 92 (1916).

147. *See* First Fed. Sav. & Loan Ass'n v. Caudle, 425 So. 2d 1050 (Ala. 1983); *but see* Brasher v. First Ala. Real Estate Fin., Inc., 447 So. 2d 682 (Ala. 1984).

standards. A borrower's chances of prevailing, however, when a loan is already delinquent under this theory seems quite remote. If the loan is already delinquent, a lender may reasonably decide not to extend the date of the loan and immediately exercise the rights against the collateral.

E. *Statutory Theories*

If the borrower is borrowing from a federal agency or has a loan guaranteed by a federal agency, the borrower may have certain statutory rights after a default. For example, borrowers who have Farmers Home Administration loans are entitled to request certain "servicing options" which may allow the debtor to reamortize, consolidate or defer the loan.[148] A discussion of these regulations is beyond the scope of this article.[149]

Farmers who have received loans from the FmHA have initiated actions against the government when those loans are called due or when further credit is not extended, alleging deprivation of a constitutionally protected property interest in FmHA benefits. Courts have denied these claims on the basis that receipt of past FmHA loan does not give rise to a constitutionally protected interest in future FmHA loans.[150]

F. *Breach of Implied Covenant of Good Faith and Fair Dealing*

There are two allegations made by plaintiffs when they believe the lender has not acted in good faith. The most common theory alleges that the lender breached its duty to act in good faith as required by the Uniform Commercial Code. The second claim, rejected by several jurisdictions, is that the lender breached the implied covenant of good faith and fair dealing.

1. *Uniform Commercial Code Duty to Act in Good Faith*

Two provisions of the Uniform Commercial Code require lenders to act in good faith. The most general provision, § 1-203 provides that "every contact or duty within this code imposes an obli-

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148. *See* Curry v. Block, 738 F.2d 1556 (11th Cir. 1984); Allison v. Block, 723 F.2d 631 (8th Cir. 1983); Coleman v. Block, 580 F. Supp. 194 (D.N.D. 1983).

149. For a good discussion of a farmer's rights when dealing with the FmHA, see Minnesota Legal Services Coalition, FARMERS GUIDE TO FMHA (1986).

150. DeJournett v. Block, 799 F.2d 430, 431 (8th Cir. 1986); Bass v. United States Dep't of Agric., 737 F.2d 1408, 1416 (5th Cir. 1984) (Garwood, J., concurring).

gation of good faith in its performance or enforcement."[151] A more specific provision, § 1-208, states that a lender may not "accelerate payment or performance or require collateral or additional collateral 'at will' or 'when he deems himself insecure'" unless the lender "in good faith believes that the prospect of payment or performance is impaired."[152]

Good faith is defined by the Uniform Commercial Code § 1-201(19) to mean "honesty in fact in the conduct or transaction concerned."[153] The honesty in fact standard is a subjective standard which examines the actual intentions of the individuals taking the action. The standard is different than the more objective standard of whether the lender's conduct is commercially reasonable.

a. *Application of U.C.C. Principles to Acceleration or Demands for More Collateral*

Courts have devised a good deal of law to measure whether a lender is acting in good faith when accelerating the loan or requiring additional collateral under the Uniform Commercial Code. To determine whether the lender acted in good faith, the belief of the lender is scrutinized. The question is whether the lender actually believed the debt was impaired, rather than whether his or her belief is accurate.[154] The lender's belief should be treated as being made in good faith if it is not "bereft of rational basis [and does not] amount to an open abuse of . . . discretionary power."[155] It is, therefore, improper for the courts to make their own determination of whether the collateral was actually impaired; rather the court should limit its inquiry as to whether the lender actually believed the collateral was impaired and whether that belief was bereft of a rational basis.

151. This provision is found at MONT. CODE ANN. § 30-1-203 (1985). The standards of the U.C.C. are similar to the standards set forth in RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

152. This provision is found at MONT. CODE ANN. § 30-1-208 (1985).

153. This provision is found at MONT. CODE ANN. § 30-1-201(19) (1985). This standard is less stringent than the good faith standard found in U.C.C. § 2-103(1)(b) of the Uniform Commercial Code which requires commercial reasonableness and thus more objective than the Article One standard. Braucher, *The Legislative History of the Uniform Commercial Code*, 58 COLUM. L. REV. 798, 812 (1958). *See also* United States v. Cain, 736 F.2d 1195, 1197 (7th Cir. 1984).

154. Smith v. Union State Bank, 452 N.E.2d 1059, 1064 (Ind. Ct. App. 1983); Fort Knox Nat'l Bank v. Gustafson, 385 S.W.2d 196, 200 (Ky. 1964); Van Horn v. Van De Wol, Inc., 6 Wash. App. 959, 961-62, 497 P.2d 252, 254 (1972).

155. K.M.C. Co., Inc. v. Irving Trust Co., 757 F.2d 752, 761 n. 12 (6th Cir. 1985); Rigby Corp. v. Boatman's Bank & Trust Co., 713 S.W.2d 517, 533 (Mo. Ct. App. 1986).

b. *Application of U.C.C. Principles to Demand Notes*

Although U.C.C. § 1-208 clearly applies to acceleration of credit or requirements of additional collateral, does the U.C.C., through § 1-203 or § 1-208, require that the lender act in good faith when calling a demand note? Since a demand note cannot by its terms be accelerated, it would seem that the provisions of U.C.C. § 1-208 should not apply to demand notes. Further, U.C.C. § 1-208 was not intended to deprive a party from enforcing its rights under a contract, in this case the right to call the loan due.[156] The issue, then, is whether U.C.C. § 1-203 applies to demands for payment of demand notes.

In *Centerre Bank v. Distributors, Inc.*,[157] the issue was whether the lender acted in good faith in demanding payment on a demand note. The borrowers argued that the lender failed to act in good faith as required by U.C.C. § 1-203 because, among other things, it demanded payment three days after it received personal guarantees to support the loan. The court rejected the borrower's argument, stating that "[t]he imposition of a good faith defense to the call for payment of a demand note transcends the performance or enforcement of a contract and in fact adds a term to the agreement which the parties had not included."[158] The court then held that lenders should not be held to the standards of U.C.C. § 1-203 when demanding payment on a demand note.

Although a lender does not violate the U.C.C. obligation of good faith by calling a demand loan, the lender may, in fact, violate the implied covenant of good faith and fair dealing found in tort law in doing so.[159]

c. *Application of U.C.C. Principles to Negotiations of Renewal or Extension of a Loan*

The good faith obligations of the Uniform Commercial Code should not apply to negotiations to renew a loan which is due or to extend new credit. The good faith requirements of U.C.C. §§ 1-203 and 1-208 by their terms apply only to existing contracts. As a result, it would seem that these provisions should not apply to the

156. *See*, R. ANDERSON, UNIFORM COMMERCIAL CODE § 1-203:11 (3d ed. 1981).

157. 705 S.W.2d 42 (Mo. Ct. App. 1985).

158. *Id.* at 48. *See also* Flagship Nat'l Bank v. Gray Distrib. Sys. Inc., 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986); Fulton Nat'l Bank v. Willis Denney Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 518 P.2d 734, *cert. denied*, 419 U.S. 967 (1974). *But see* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985).

159. *See infra* text accompanying notes 167-206.

negotiations to loan money where no loan exists currently, or to extend the due date of a loan. When a loan is due, it is akin to a demand loan. The rationale that U.C.C. § 1-203 does not apply to demand loans should apply with equal force to loans which are past due.[160]

There should be one exception to this rule: a duty of good faith should apply when a lender makes a loan commitment, which is, in and of itself, a contract. In that case, both the lender and the customer have a duty to act in good faith when negotiating the final and definitive terms of the documents necessary to effectuate the loan. The parties, in essence, have entered a contract to enter a more definitive contract, thus the good faith duty should be applied.[161]

d. *Remedies for Violation of the U.C.C. Duties of Good Faith*

Considerable confusion exists as to whether a lender's failure to act in good faith as required by the U.C.C. results in both a breach of contract (and contract damages) and a separate tort (with tort and possibly punitive damages). The most definitive statement that tort damages are available for a breach of U.C.C. § 1-203 or § 1-208 is the Montana Supreme Court decision in *First National Bank in Libby v. Twombly*,[162] which states "when the duty to exercise good faith is imposed by law rather than the contract itself the breach of that duty is tortious."[163] The Montana Supreme Court likened the conduct of the bank to that of the insurance company in *Gates v. Life of Montana Insurance Company*,[164] and held that tort damages were appropriate.[165]

States which do not recognize the tort of breach of the implied covenant of good faith and fair dealing, generally do not recognize

160. Comment c to the RESTATEMENT (SECOND) OF CONTRACTS also recognizes that the duty of good faith "does not deal with good faith in the formation of a contract," RESTATEMENT (SECOND) OF CONTRACTS § 205 comment c (1981). It should be noted, however, that one court found that a lender could be liable for failing to give adequate notice that it would not advance further funds when there was a pattern of prior advances and where the debtor was able to make regular and continued payments. *K.M.C. Co.*, 757 F.2d at 760-63. The notice rule of *K.M.C. Co.*, however, should not apply "if the lender had reason to believe that the borrower would not be capable of payment or performance, or if the borrower otherwise falls outside the lender's eligibility guidelines." East Lansing State Bank v. Red Cedar Constr., 63 Bankr. 228, 238 (W.D. Mich. 1986).

161. *See, e.g.*, Teachers Ins. & Annuity Ass'n of Am. v. Butler, 626 F. Supp. 1229, 1232 (S.D.N.Y. 1986) ("courts will enforce a duty of good faith, including good faith negotiation, in order that a party not escape from the obligation he has contracted to perform").

162. ___ Mont. ___, 689 P.2d 1226 (1984).

163. *Id.* at ___, 689 P.2d at 1230.

164. ___ Mont. ___, 668 P.2d 213 (1983).

165. *Twombly*, ___ Mont. at ___, 689 P.2d at 1230.

that breach of the U.C.C. duty of good faith amounts to a tort.[166] Courts in these states reason that the provisions of U.C.C. § 1-106 expressly provide that damages for violation of such provisions as U.C.C. §§ 1-203 or 1-208 are contract damages.[167] These courts further argue that to allow courts to test the good faith of a lender under tort standards of reasonableness would vitiate the "honesty in fact" standard of the U.C.C.

2. *Breach of Implied Covenant of Good Faith and Fair Dealing*

The Montana Supreme Court and legislature have been on the leading edge of a trend which holds lenders liable for tort damages as a result of a breach of the implied covenant of good faith and fair dealing when applied to the extension of credit. The standard which the Montana Supreme Court applies was set forth in *Nicholson v. United Pacific Insurance Co.*[168] In *Nicholson*, the court set forth the following standard: "The nature and extent of an implied covenant of good faith and fair dealing is measured in a particular contract by the justifiable expectation of the parties. The second party then should be compensated for damages resulting from the other's culpable conduct."[169]

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166. Nobs Chemicals, U.S.A., Inc. v. Koppers Co., Inc., 616 F.2d 212, 214 (5th Cir. 1980); Interco, Inc. v. First Nat'l Bank, 560 F.2d 480, 485 (1st Cir. 1977); Allied Canners & Packers, Inc. v. Victor Packing Co., 162 Cal. App. 3d 905, ____, 209 Cal. Rptr. 60, 65 (1984); Hall v. Owen County State Bank, 175 Ind. App. 150, 172, 370 N.E.2d 918, 927 (1977); Rigby Corp. v. Boatman's Bank and Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986); Waters v. Trenckman, 503 P.2d 1187, 1191 (Wyo. 1972).

167. U.C.C. § 1-106 states "[t]he remedies provided by this chapter shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed but neither consequential or special nor penal damages may be had . . . ."

168. ____ Mont. ____, 710 P.2d 1342 (1985). The four Montana cases discussing the application of the tort of bad faith to lenders were decided before *Nicholson*. *See* Central Bank v. Eystad, ____ Mont. ____, 710 P.2d 710 (1985); First Nat'l Mont. Bank v. McGuiness, ____ Mont. ____, 705 P.2d 579 (1985); Tribby v. Northwestern Bank, ____ Mont. ____, 704 P.2d 409 (1985); *Twombly*, ____ Mont. ____, 689 P.2d 1226. The Montana Supreme Court used *Nicholson* as an opportunity to "fully articulate" its view of the law. *Id.* at ____, 710 P.2d at 1347. *Nicholson*, however, was cited by the Montana Supreme Court as the standard for the application of the tort of bad faith to the commercial setting. *See* Thiel v. Johnson, ____ Mont. ____, 711 P.2d 829 (1985); McGregor v. Mommer, ____ Mont. ____, ____, 714 P.2d 536, 543 (1986); Dunfee v. Baskin-Robbins, ____ Mont. ____, 726 P.2d 1145 (1986).

169. *Nicholson*, ____ Mont. at ____, 710 P.2d at 1348. Montana also has codified the definition of the implied covenant of good faith and fair dealing. *See* 1987 Mont. Laws ____ (House Bill 592). The Montana Legislature has defined "[t]he conduct required by the implied covenant of good faith and fair dealing [as] honesty in fact and the observance of reasonable commercial standards of fair dealing in trade." *Id.* The effect of this legislation is to test the defendant's conduct under both the subjective ("honesty-in-fact") standard and the objective (commercial reasonableness) standard. If either standard is violated, the de-

The application of the notion that banks must act in good faith was first made in *First National Bank in Libby v. Twombly*.[170] Craig and Lorraine Twombly obtained a commitment from Johnson, a Vice President of the First National Bank in Libby, to convert a promissory note to an installment note if the Twomblys made "some reduction" of principal and paid the accrued interest. When the Twomblys were ready to sign the loan papers, they learned that they would have to deal with a different Vice President, Haines, because Johnson was out of town. Haines refused to convert the note and offset the amount of the Twomblys' promissory note against the Twomblys' checking account, leaving the Twomblys with a checking account balance of $1.65. The Twomblys were not given notice of the offset and Craig Twombly first learned about the bank's offset when he tried to cash a check. Twombly tried to discuss the matter with Haines twice but was unable to do so. Haines argued he took the action that he did because Twombly said he would not pay the note. To cover the dishonored checks, the Twomblys were forced to sell assets of their business.[171]

The Supreme Court measured the bank's conduct (accelerating the note and offsetting the debt against the checking account) against the standards set by the Montana Uniform Commercial Code. The court focused on UCC § 1-203 which provides: "Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement."[172]

The jury found, and the court sustained, that the bank breached the statutory obligations to act in good faith and that it

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fendant has breached the implied covenant. Presumably this definition of a breach of the implied covenant of good faith and fair dealing found in this legislation is consistent with the definition found in the *Nicholson* case. In order for a party's conduct to exceed the justifiable expectation of the others, the party must act "arbitrarily, capriciously or unreasonably." ___ Mont. at ___, 710 P.2d at 1342. Subsequent cases interpreting *Nicholson* have made it clear that it was the court's intent to require more than a subjective test, but also an objective test. McGregor v. Mommer, ___ Mont. ___, ___, 714 P.2d 536, 543 (1986). It would seem, then, that the rationale of the Montana Supreme Court espoused in cases decided before 1987 Mont. Laws ___ (House Bill 592) will still be determinative in deciding when the implied covenant of good faith and fair dealing has been breached. Further, 1987 Mont. Laws ___ (House Bill 592) defines conduct required when the implied covenant exists, but is silent as to when the covenant is implied. As a result, whether the covenant is implied will still depend upon the reasonable expectations of the parties as discussed in *Nicholson*.

170. ___ Mont. ___, 689 P.2d 1226 (1985).

171. *Id.* at ___, 689 P.2d at 1228-29.

172. The court also examined MONT. CODE ANN. § 30-1-208 (1985) which provides that a bank may only accelerate pursuant to an "at will" acceleration clause or similar clause if the bank "in good faith believes that the prospect of payment or performance is impaired." *Twombly*, ___ Mont. at ___, 689 P.2d at 1229.

made false representations to Twombly. A breach of the statutory obligation, it held, was tortious and punitive damages were reasonable.[173]

The *Twombly* case was criticized in *Rigby Corp. v. Boatmen's Bank and Trust Co.*,[174] as "not expound[ing] a rationale consonant with that integral rationale of the [Uniform Commercial] Code."[175] The Missouri court argued that U.C.C. § 1-106, by its terms, does not allow punitive damages and "confines recovery for the breach of a Code obligation—§ 1-203— to the contours of a contract breach, and hence that § 1-203 imposes a duty of contract and not tort."[176] The criticism that U.C.C. § 1-203 does not provide for punitive damages is unjust because U.C.C. § 1-106 enables the aggrieved party to resort to other rules of law.[177] Furthermore, there is nothing in the Uniform Commercial Code to suggest that it preempts the general tort law of the state which may allow for tort damages if the implied covenant of good faith and fair dealing is breached.

The court, in *Twombly*, sent confusing signals to the bar about whether the obligation "good faith" would be broadly applied to lenders. The court specifically noted that the case presented "a rather unique fact situation."[178] Only three days after the *Twombly* decision, however, in *Tribby v. Northwestern Bank of Great Falls*,[179] the court held it was proper for the district court to instruct the jury to consider recovery under the tort principles in accordance with the rationale of the *Twombly* case.[180] In *Tribby*, the bank allegedly wrongfully honored checks drawn on a partner-

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173. *Twombly*, ___ Mont. at ___, 689 P.2d at 1270. Other courts have also held that breaches of good faith provisions of U.C.C. §§ 1-203 and 1-208 may result in tort damages. *See* Nobs Chemical, U.S.A., Inc. v. Koppers Co., 616 F.2d 212, 215 (5th Cir. 1980); Interco, Inc. v. First National Bank, 560 F.2d 480, 485 (1st Cir. 1977); Allied Canners & Packers, Inc. v. Victor Packing Co., 162 Cal. App. 3d 905, 914, 209 Cal. Rptr. 60, 65 (1984); Hall v. Owen County State Bank, 175 Ind. App. 150, 172, 370 N.E.2d 918, 927 (1977); Rigby Corp. v. Boatmen's Bank and Trust Co., 713 S.W.2d 517 (Mo. Ct. App. 1986); Waters v. Trenckman, 503 P.2d 1187, 1191 (Wyo. 1972). *See* Skeels v. Universal C.I.T. Credit Corp. 335 F.2d 846 (3d Cir. 1964); McKay v. Farmers & Stockmens Bank, 92 N.M. 181, 585 P.2d 325 (Ct. App.), *cert. denied*, 92 N.M. 79, 582 P.2d 1292 (1978). The bulk of the decisions, however, have rejected the position that a breach of U.C.C. §§ 1-203 and 1-208 give rise to a tort action.

174. 713 S.W.2d 517 (Mo. Ct. App. 1986). Other courts have also rejected the tort of bad faith in farmer/lender disputes. *See, e.g.*, North Cent. Kan. Prod. Credit Ass'n v. Hansen, ___ Kan. ___, ___, 732 P.2d 726, 731 (1987).

175. *Rigby Corp.*, 713 S.W.2d at 536.

176. *Id.*

177. In this case, MONT. CODE ANN. § 27-1-221 (1985) provides for an award of punitive damages where malice, oppression, or fraud are shown.

178. *Twombly*, ___ Mont. at ___, 689 P.2d at 1230.

179. ___ Mont. ___, 704 P.2d 409 (1985).

180. *Id.* at ___, 704 P.2d at 419.

ship's land account. When the customer sued the bank, the bank allegedly retaliated by refusing to renew a loan that had been renewed annually for several years and by refusing to make automatic loan advances. The court, in holding that it was proper to give the instruction, noted that the bank stood "in the position of superior bargaining power" and that there was evidence of "reckless disregard" for the borrower's rights.[181] The court cautioned "[w]e are not holding that every contract or statutorily imposed obligation, alone, carries with it an implied covenant of good faith and fair dealing, the breach of which permits recovery in tort."[182]

In *Twombly* and *Tribby*,[183] the Montana Supreme Court described when refusals to extend or renew credit amount to tortious conduct, and in *First National Montana Bank of Missoula v. McGuiness*,[184] and *Central Bank of Montana v. Eystad*,[185] the court described when refusals to extend credit are not tortious conduct. In *McGuiness*, the borrowers alleged that the bank had falsely led them to believe that it would not foreclose if they subdivided their ranch. The bank, the court found, applied "subtle pressure" to use the services of a real estate developer who was also the nephew of an officer and director of the bank.[186] The subdivision of the land did not result in sufficient proceeds to avoid foreclosure.[187] The lower court found that the bank had not violated its covenant of good faith and fair dealing and the Montana Supreme Court agreed. The supreme court found that subdivision of the land resulted in sizable reduction in the amount of the debt. The court held that the position taken by the bank "can hardly be characterized as anything but good business sense both for the bank and for the McGuinesses."[188] The court properly found that the bank was not liable for its suggested course of action, subdivision of the land, even though the bank's recommendation did not

181. *Id.*

182. *Id.*

183. In addition to *Twombly* and *Tribby*, the borrower was also successful with a bad faith cause of action in Thiel v. Johnson, ___ Mont. ___, 711 P.2d 829 (1985). In that case the Thiels entered into a contract to sell a motel. After waiving defaults for four months, the Thiels suddenly, without notice, declared a default and repossessed the premises. The fact that the Thiels did so in accordance with a court order did not excuse Thiels' conduct because they obtained the court order improperly. *Id.* at ___, 711 P.2d at 831.

184. ___ Mont. ___, 705 P.2d 579 (1985).

185. ___ Mont. ___, 710 P.2d 710 (1985).

186. The subtle pressure included a letter from the bank expressing displeasure about the borrower's inability to consumate a deal with the nephew. *McGuiness*, ___ Mont. at ___, 705 P.2d at 581.

187. *Id.* at 582.

188. *Id.* at ___, 705 P.2d at 585-86.

produce sufficient income to fully pay the loan.[189]

In *Eystad*, the court dealt with an operating loan which had been renewed for several six-month periods, prior to nonrenewal and foreclosure. The borrowers alleged that the bank had engaged in the "practice and course of conduct" of renewing the loans and that the bank had changed this business practice without adequate notice.[190] The borrower further alleged this practice constituted the tort of bad faith. The supreme court affirmed the district court's judgment that the bank did not breach any implied covenant of good faith and fair dealing. The court specifically noted that the bank acted "with justifiable *business judgment* in foreclosing"[191] and that the bank was "candid and reasonable" with the borrower because they repeatedly gave the borrowers notice that the loan would not be renewed.[192] Like *McGuiness*, the court focused on whether the judgment of the bank was reasonable.[193]

The line between when the lender meets the reasonable expectation of the borrower and when it does not has not been clearly delineated by the Montana Supreme Court.[194] Unfortunately, because the law concerning breach of the implied covenant of good faith and fair dealing is only now evolving, there is little guidance from other courts as to what conduct is reasonable and what is not.

A good elaboration of when bank conduct is unreasonable and when a bank is culpable for a bad faith refusal to extend credit may be found in *K.M.C. Co., Inc. v. Irving Trust Co.*,[195] In *K.M.C. Co.*, the bank refused to extend additional credit to the borrower. The Sixth Circuit affirmed the district court's finding of bad faith. Among the factors noted by the court, as evidence of bad faith,

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189. *Id.* at ____, 705 P.2d at 586.

190. *Eystad*, ____ Mont. at ____, 710 P.2d at 712-13.

191. *Id.* at ____, 710 P.2d at 713 (emphasis added).

192. *Id.* at ____, 710 P.2d at 714.

193. The standard of business judgment was discussed in Dunfee v. Baskin-Robbins, Inc., ____ Mont. ____, 720 P.2d 1148 (1986) without the business judgment label being applied. The court, when dealing with Baskin-Robbins' refusal to change the terms of a lease, stated that it "recognized the contractual right of Baskin-Robbins to refuse relocation on the basis of cost or other economic circumstances." The court was critical of Baskin-Robbins because the only person at Baskin-Robbins who could approve of the move was not told of the relocation request. One would expect, however, that the employees of Baskin-Robbins were only following the normal business practice of screening relocation requests prior to submitting a select group to the employee with the ultimate authority. Burnham, *Bad Faith: Court Finds Breaches of Fair Dealing Applicable to Commercial Contracts*, THE MONTANA LAWYER, Nov. 1986 at 6, 9 ("Bad business judgment alone should not constitute the kind of unreasonable conduct that is actionable as bad faith in a commercial setting.").

194. Likewise, 1987 Mont. Laws ____ (House Bill 592) does nothing to define what conduct is reasonable or what conduct is not.

195. 757 F.2d 752 (6th Cir. 1985).

were

> (1) a personality conflict between the loan officer and a manager of the borrower;[196]
> (2) the loan officer's conduct violated a policy of the bank;[197]
> (3) "any reasonable banker looking at the loan would agree that it was fully secured";[198] and,
> (4) failure to give reasonable notice that credit would be terminated and the bank's knowledge of that termination would "destroy" the borrower.[199]

The court adopted a "business judgment" standard when measuring the conduct of the bank. In discussing whether the bank was liable, the court looked at more than the actual mental state of the officers of the bank. The court stated:

> While it is not necessary that [a bank officer] have been correct in his understanding of the facts and circumstances pertinent to his decision not to advance funds for this court to find that he made a valid business judgment in doing so, there must at least be *some* objective basis upon which a reasonable loan officer in the exercise of his discretion would have acted in that manner.[200]

The business judgment standard described in *K.M.C. Co.* was alluded to in the Montana cases of *McGuiness* and *Eystad*.[201] In both cases, the Montana Supreme Court acknowledged that where the bank exercised "good business sense" or "justifiable business judgment," the claim for a breach of the implied covenant should fail. By using the words "good" and "justifiable" to modify the words "business" and "business judgment," one may assume courts in states which recognize the covenant would examine more than the mental state of the bank officer, but would examine the record to determine whether there is some objective basis for the officer's decision.[202] The justifiable business judgment standard, of course,

196. *Id.* at 761.
197. *Id.*
198. *Id.* at 761-62.
199. *Id.* at 762. "If [the lender] had given K.M.C. 30 days, 7 days, even 48 hours notice, we would be facing a different case." *Id.* at 763.
200. *Id.* at 761 (emphasis in original). A Missouri Court of Appeals has distinguished a case involving a demand note from the line of credit in *K.M.C. Co.*, because *K.M.C. Co.* dealt with the failure to extend credit "suddenly and without notice." *Id.* at 48. In *Centerre Bank, Inc.*, 705 S.W.2d 42, the court stated that the duty of good faith and U.C.C. § 1-203 should not apply to demand notes. Demand notes are due when called, for whatever reason; the U.C.C. should not be used to add other terms to a demand note. *Id.* at 47, 48. *See also* Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 518 P.2d 734, *cert. denied*, 419 U.S. 967 (1974).
201. *See supra* text accompanying notes 184-93.
202. Likewise 1987 Mont. Laws ___ (House Bill 592) requires the courts to use an

should be applied in such a way as to protect the borrower's reasonable expectations while preserving the bank's ability to protect its capital and provide a return to shareholders.

The California Supreme Court in *Wagner v. Benson*[203] offered a sound rationale for respecting a bank's interest in protecting its collateral and the ability to operate profitably. The court acknowledged that the law of torts, including a bad faith cause of action, must achieve a desirable social climate and that " 'public policy' plays a major role in determining the standard of conduct required by a particular situation."[204] The court found that public policy did not require a bank to assume liability for hardships which befall the borrowers. To do so would "dramatically alter the risk undertaken by the bank in the loan agreement."[205] The court correctly recognized that the implied covenant of good faith and fair dealing required the bank to ensure that the borrower had the benefit of the bargain, but not to ensure the success of the borrower.[206]

III. Suggestions for Future Directions

The foregoing analysis demonstrates that courts have difficulty dealing with the wide variety of theories asserted by a borrower as a result of an unexpected termination of credit. Some judges and juries are naturally sympathetic with the farmers and other businesses which have expanded with money borrowed from lenders and have faced a relatively sudden termination of credit, usually due to factors beyond their control.[207] Courts in most reported cases, have rejected borrower claims that a contract existed to extend credit. Courts hesitate to find that lenders assent to an agreement unless the agreements are sufficiently definite to amount to an enforceable contract. If courts believe the lender conduct is sufficiently culpable to require a finding of liability, they have usually relied on tort theories to do so. Because tort law balances competing public policy concerns, those concerns must be

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objective standard.

203. 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980). At the time this case was decided the California court had not decided that a bad faith action could arise from a borrower-lender relationship, so its analysis is arguendo.

204. 101 Cal. App. 3d at 34, 161 Cal. Rptr. at 520 (citing W. Prosser, Torts § 3, at 15-16 (4th ed. 1971)).

205. *Id.* at 34, 161 Cal. Rptr. at 521.

206. *Id.*

207. According to A. Barry Cappello, California plaintiffs' attorney, who represents disgruntled borrowers, ". . . jurors typically perceive the farmer-banker relationship as David against Goliath and, as a result, routinely award large verdicts to punish banks for what they think is malicious or outrageous conduct." Cappello, *One Farmer's Resolution*, Western Banker 24 (May 1986).

identified and analyzed.

A. *The Need to Limit the Duty of the Bank to Act Reasonably*

Courts should avoid the temptation to hold lenders liable for borrowers' losses any time a trier of fact believes the conduct of the bank is "unfair."[208] In addition, instances in which the lender's judgment should be tested against the *objective* reasonable business judgment standard of the *K.M.C. Co., Inc.* case (and alluded to in *Eystad* and *McGuiness*) should be limited to circumstances in which the borrower has a reasonable expectation[209] that the credit decisions will be made in good faith, or the lender has undertaken a duty[210] to act reasonably with respect to a credit determination. For example, if a loan is in default because of a failure to pay an installment when due or a note is past due, the borrower has breached its contract with the lender and should not expect to hold the lender to an objective reasonable banker standard when the lender evaluates whether the collateral is sufficient to extend new credit. The borrower, in essence, is applying for new credit and is not operating under the old loan agreements. The most the borrower who has breached the contract to repay the lender is entitled to expect, absent extraordinary circumstances, is that the lender commence collection action.[211] Although a borrower may not reasonably expect a lender to extend a new loan after the existing loan is in default, it may expect the lender to act in good faith under the old loan, by giving timely notice of nonrenewal if

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208. The problem with courts succumbing to pressures to attempt to solve the farm crisis were accurately described by a Minnesota bankruptcy judge:

> [I]t is crucial that the Bankruptcy Courts, as trial courts, do not succumb to the temptation, which invariably arises from the more distressed cases, to fashion political solutions to general economic problems under the guise of administering proper judicial remedies. Otherwise, the integrity of the Bankruptcy Courts, and the judicial process itself, will become seriously eroded to the point where chaos and cynicism will replace calm and reason; ultimately rendering the fabric of law and destroying the credibility of the courts.

In re Haukos Farms, Inc., 68 Bankr. 428, 437 (1986).

209. The reasonable expectation should be the one described in Nicholson v. United Pac. Ins. Co., ___ Mont. ___, ___, 710 P.2d 1342, 1348 (1985). *See supra* text accompanying notes 168-69.

210. Whether a bank has undertaken a duty to act reasonably is discussed in *Jacques*, 307 Md. at 527, 515 A.2d at 756. *See supra* text accompanying notes 134-47.

211. The results should be the same under 1987 Mont. Laws ___ (House Bill 592). If there is a default in the loan, it would appear to be commercially reasonable for the lender to commence collection actions. Even the lesser subjective standard of U.C.C. § 1-203, honesty in fact (U.C.C. § 1-201(19)), does not apply to decisions for new credit unless there is a duty. The U.C.C. duty applies to "contracts," but not a party's consideration whether to enter into new contracts.

there has been a pattern of renewals or if the borrower has been lead to believe the loan would be renewed.

To measure the lender's decision not to extend new credit after a loan is due and in default against an objective reasonableness standard would place an undue burden on the lenders. While a lender must objectively act in good faith under the terms of an existing loan, the requirement to act in good faith when making a new loan after the existing loan is due would place a burden on the lender by making it difficult to terminate credit. Thus, a lender's decision not to extend new credit, from an objective standpoint, may not have been commercially reasonable, but, from a more subjective standpoint, may have been made by the officer of the lender based on his or her fear that the bank's position is jeopardized. For example, a farmer may be required to pledge land to the lender originally worth $500,000.00 to secure a $300,000.00 loan. Suppose the land declines in value to $400,000.00 and the loan is due. Assume further that land prices have stopped falling and the bank's $100,000.00 "cushion" is unlikely to shrink. The lender's officers may, in subjective good faith, be more concerned about the loan now than when it was originally made. If the bank officers have any doubt about the borrower's ability to make timely payments on the loan, they ought to be able to decline extending any further or increased credit without incurring tort liability because they fail to meet an objective standard of good faith. Further, if a second farmer is able to offer $600,000 in collateral to support the same $300,000 loan, the lender ought to be able to collect from the first farmer and offer the loan funds to the farmer who is the better credit risk. Only then will the lender be able to realize the benefits which it expected when it originally bargained for the loan.

Several arguments can be made for the proposition that the objective standard of good faith should not be extended to decisions to offer further credit.[212] Those reasons include the need to avoid restricting available lender credit and the inappropriateness of any application of the deep pocket theory to transfer liability to lenders.

1. *Unnecessary Restriction of Credit*

As in any other business, lenders make decisions based on the relative amount of risk and reward. Because the amount of a lender's reward (rate of interest) is limited by law (usury statutes),

212. For the purposes of this article the term "further credit" means new credit, an extension of the due date of the loan, or additional credit.

lenders are hesitant to make loans unless the amount of risk can be controlled. Risks entail the possibilities of failure of the farm, decline in value or dissipation of the collateral, bankruptcy of the farmer; but should not include excessive risks of lawsuit if the lender denies further credit after the loan is due. In those cases where the risks associated with extending credit are nearly equal to the rewards, additional risk such as a substantial expansion of the theory of lender liability will tip the balance against extending credit to farmers or other borrowers if the lender believes they are litigious.[213] If the balance is tipped in that direction, the marginal borrowers who need credit the most may be excluded from credit markets.

In addition to restricting availability of credit, shifting more losses to lenders will result in higher interest rates for those who are able to get credit. Although some of the losses due to lender liability may be initially transferred to shareholders, those losses will make it more difficult for lenders to attract funds to lend.[214] In order to attract funds, loan terms often are made harsher.

The problem of discouraging private lenders from extending credit to the farm markets is particularly acute. Several major banks are already making efforts to reduce the amount of lending to farm and ranch businesses.[215] Top government banking officials have urged agricultural lenders to increase the diversification of their borrower base—presumably away from agribusiness.[216] Farm banks, already weakened by the farm economy,[217] are often not

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213. The author recently has heard several representatives of agribusiness suggest that the enactment of Chapter 12, Family Farmer Bankruptcy Act, which provides for debt relief for farmers faced with bankruptcy, has had the effect of further restricting the availability of farm credit, especially to farmers whose operations are not highly profitable. Empirical studies are needed to confirm the author's suspicions that these reports are accurate. The author, however, is not alone in being concerned about the restrictions on the availability of farm credit. After discussing a court decision which placed more risk on bankers as well as new bankruptcy law changes and agricultural loan changes, it was concluded that agriculture credit may dry up for farmers with weaker financial conditions. Cade, *Around the Big Sky Country* at 3 (January 1, 1987) (quoting Robert Ranger, Chairperson of the American Bankers Association, Agricultural Division). *See also*, Allen, *Saving the Family Farm*, 7 CAL. LAW. 8 (March 1987).

214. U.S. Dep't of Agric., *How Healthy Are Rural Banks*, FARMLINE, August 1986 at 10-11. For a discussion of the impact of Farm Credit System Losses, see U.S. Dep't of Agric., *The Farm Credit System: Troubled Past, Uncertain Future*, May 1986 at 23, 27.

215. S. Lehrman, *Financially Ailing Farmers Take Their Battle to the Courtroom*, San Francisco Examiner, March 19, 1986, at A-4, col. 3.

216. Statement of Robert L. Clarke, Comptroller of the Currency Before the Committee on Banking, Housing, and Urban Affairs, United States Senate (March 11, 1986) at page 17.

217. In 1985, 68 farm banks failed. The number of farm banks in serious financial trouble "has risen substantially." *Farm Credit Administration Act Amendments of 1985,*

anxious to make more of the agriculture loans which created,[218] for many of them, serious problems of survival.

2. *Liability for Farm Credit Problems Ought Not Be Shifted to Lenders*

When a borrower faces losses and sues, alleging a tort theory, because the lender terminates credit, courts may legitimately examine public policy to determine allocation of liability and the proper standard of conduct.[219] An expansion of the implied covenant of good faith and fair dealing to the lender's decision to extend further credit after a borrower's default would shift greater burden for the farm credit crisis to lenders. The temptation to make this shift should be avoided. Public policy does not, and has never, imposed upon the lender liability for the hardships suffered by the businesses it finances.[220] The risk that the lender undertakes is that its collateral will not support the loan. Banks attempt to minimize the risk by including the appropriate terms in its loan documents, including a definite due date. Novel theories which seek to alter the benefits for which the lender bargained have been rejected[221] and should continue to be rejected. The risks associated with farming and the profitability of farming operations, of course, are best controlled by farmers who make the decisions on types of crops or livestock to raise and who have the power to determine whether commodity prices are so low that nothing should be raised. The costs of incorrect decisions, whether or not the decisions were warranted at the time, should be borne by those who

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Before the Senate Comm. on Banking, Housing and Urban Affairs, 99th Cong., 2nd Sess. 127 (1986) (statement by Preston Martin, Vice Chairman, Board of Governors of the Federal Reserve System). One hundred sixty-two of the 861 national agriculture banks reported losses at year end in 1984. As of December 1985, 12 percent of national agricultural banks were considered "problem institutions" by the Comptroller of the Currency. *Farm Credit Administration Act Amendments of 1985 Before the Senate Comm. on Banking, Housing and Urban Affairs, United States*, 99th Cong., 2nd Sess. 111 (1986) (statement of Robert L. Clarke, Comptroller of the Currency).

218. As of the fourth quarter of 1985, only 38% of the rural banks in the Ninth Federal Reserve District, which extends from Montana to the Upper Peninsula of Michigan, were actively seeking new farm accounts. As of late 1986, that number has increased to 69%. Federal Reserve Bank of Minneapolis, *Agricultural Credit Condition Survey* 4 (4th Quarter 1986).

219. W. Prosser, Torts § 3 at 15-16 (4th ed. 1971). *See also* Wagner v. Benson, 101 Cal. App. 3d 27, 32, 161 Cal. Rptr. 516, 520 (1980).

220. *See Wagner*, 101 Cal. App. 3d at 34, 161 Cal. Rptr. 516, 520, Fox & Carskadon Fin. Corp. v. San Francisco Fed. Sav. & Loan Ass'n, 52 Cal. App. 3d 484, 489, 125 Cal. Rptr. 549, 552 (1975).

221. *See Wagner*, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516; Universal Sales Corp. v. Cal. Press Mfg. Co., 20 Cal. 2d 751, 128 P.2d 665, (1942).

have the greatest opportunity to control the risks, in most cases, the borrowers.

It is easy to sympathize with the plight of the United States farmer. The recent decline of the farm economy is due to factors beyond the control of the farmer, including world recession, United States trade policies (including the grain embargo of the Soviet Union), and federal government farm programs which have resulted in increased world production.[222] The fact that many of the farmers' financial problems were caused by policies of the federal government, however, does not justify a shift in liability to the banks. Banks, themselves, have also been victims of restrictive federal policies which have restricted their profitability.[223] If it is determined that farmers ought to be provided a "safety net" in the form of a continued source of assured credit, it is most efficient to accomplish that objective through expanded use of such social welfare programs as the Farmers Home Administration Limited Resource Eligibility Loan Program[224] or loan moratorium or deferral programs on FmHA loans.[225] It has long been recognized that social insurance programs may more efficiently allocate risks which cannot or are not insured against, than the enterprises which are partially responsible for the risk. Holding enterprises such as banks or the Farm Credit System liable for these risks causes more social disruption (bank failures[226] and injury to innocent shareholders and uninsured depositors) than would social insurance.[227]

Social insurance programs, however, are not without their own costs. Social insurance programs frequently fail to address the fundamental problem facing agriculture in the United States: high

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222. *See* U.S. Dep't of Agric. Econ. Research Serv., *Reviving U.S. Exports: Why is It Taking So Long*, FARMLINE, Feb. 1986 at 8-10. Senator Charles E. Grassley of Iowa recently stated "most of the difficulties that farmers face, whether they be falling land values, high interest rates, low commodity prices, the law of export markets, increased competition from imports — practically all of those things can be attributed to ill-considered Government policies." *Farm Credit Administration Act Amendment of 1985 Before the Senate Comm. on Banking, Housing and Urban Affairs*, 99th Cong., 2nd Sess. 8 (1986).

223. *See* Jewett & Lane, *Averting the Next Crisis in Banking*, THE BANKER'S MAGAZINE, Jan-Feb 1986 at 29 and Fraser, *Deregulation and Depository Institutions*, THE BANKER'S MAGAZINE, Jan-Feb 1983 at 34.

224. For a description of this program, see 7 C.F.R. § 1943.4(g) (1986). For a description of other farm loan programs, see Meyer & Wadley, *Agricultural Law* 1982 at 367-81.

225. *See* 7 U.S.C. § 1981(d) (1986).

226. If a rural bank fails, many of its borrowers in a weak financial condition are unable to find new lenders. The FDIC is forced to foreclose and land values in the community are driven down. Melcher, *Agricultural Banks Under Stress*, FEDERAL RESERVE BULLETIN, July 1986, at 437.

227. *See* Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J., 499, 528-32 (1961).

land prices and overproduction resulting in low market prices. Social programs such as price supports or price floors encourage more production overseas which, in the long run, result in further downward pressure on farm profits.[228] Likewise, if the social programs take the form of subsidized federal credit, farm profit may further erode because with more money being invested in farming, agricultural output will increase. The result will be more erosion in farm profitability.[229]

Making credit easier to obtain from traditional farm lenders under the threat of legal action will have the same consequence as subsidized federal credit. Shifting some of the farmers' losses to the lenders will of course increase the profitability of farming, but will also result in inflated land values. It is those inflated land prices and the resultant borrowing against land values that is at the root of problems of farmers with financial difficulty. While most farmers, including those with financial difficulty, are generating an operating profit, they experience negative cash flow because of high debt payments.[230] Declining land prices, though painful to the individual farmers with substantial debt, are needed in order to restore international cost competitiveness to the entire farm sector. A policy which shifts losses to banks will impede this process,[231] and will jeopardize the entire farm economy. Social programs designed to help a relatively few in the short run could jeopardize many more viable farms in the long run.

B. *Application of the Duty to Act Reasonably to Tort Claims*

As has been discussed, tort law attempts to allocate responsibility for loss by balancing public policy considerations. The two competing public policy considerations when credit is terminated are the borrower's need for available sources of credit and the lender's need to act quickly to minimize its losses. Borrowers have a need for credit and a need to be given adequate notification before credit is terminated. Adequate notice allows commercially viable borrowers the opportunity to find replacement credit. Consistent with the borrower's right to reasonable notice, lenders

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228. *See* U.S. Dep't of Agric. Econ. Research Serv., *Reviving U.S. Exports: Why Is It Taking So Long?*, FARMLINE, Feb. 1986 at 8-10.

229. *See* U.S. Dep't of Agric. Econ. Research Serv., *Reassessing the Federal Role in Farm Credit*, FARMLINE, Feb. 1985 at 16-18.

230. *See* Melcher, *Agricultural Banks Under Stress*, FEDERAL RESERVE BULLETIN, July 1986, at 437, 440-41.

231. *See* Thompson, *Global Trends in Supply and Demand*, AGRIC. OUTLOOK, Jan-Feb 1986 at 2-6.

ought to be able to make credit termination decisions in a way that maximizes their profit. Lenders should not be forced to fear second guessing with respect to credit decisions to either extend or refuse to extend further credit by being held to an objective standard of commercial reasonableness.[232] As recognized by the Montana Supreme Court, the implied covenant of good faith should not be interpreted in such a way to discourage business from making necessary decisions.[233] Nonetheless, examination of whether *lenders' notice* to the creditors and other statements and actions are reasonable does not place as much a burden on the bank as scrutiny of the *lender's decision to extend further credit.*

The lender's right to make a business decision respecting further credit is not threatened by any of the tort theories described except for the duty owed to process a loan without negligence and the application of the implied covenant of good faith and dealing. All other tort theories scrutinized how the credit decision is presented to the borrower, which is less sensitive than scrutinizing the actual credit decision itself.

1. *Negligence in Processing a Loan Application*

The case of *Jacques v. First National Bank*[234] should be limited in its application to those cases where there is a formal loan application and where the lender expressly undertakes a duty to review the application against identifiable loan standards.[235] The theory of this case should not be expanded to enable courts to review all credit determinations on the basis of whether the decisions were commercially reasonable. Unless the bank specifically undertakes to make a credit decision to extend a loan using reasonable or identifiable standards, the bank ought to be protected from liability if it makes the decision to deny credit so long as its actions do not give rise to a contract to extend credit or amount to some type of fraud. The bank that solicits applications for new loans,

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232. In a scathing criticism of the implication of the covenant of good faith and fair dealing, the Texas Supreme Court stated: "The novel concept . . . [the implied covenant of good faith and fair dealing] would abolish our system of government according to settled rules of law and let each case be decided upon what might seem fair and in good faith by each fact finder."

English v. Fischer, 660 S.W.2d 521 (Tex. 1983). *See also* Cluck v. Frost Nat'l Bank of San Antonio, 714 S.W.2d 408 (Tex. Ct. App. 1986).

233. Dunfee v. Baskin-Robbins, ____ Mont. ____, 720 P.2d 1148 (1986).

234. 307 Md. 527, 515 A.2d 756 (1986). *See supra* text accompanying notes 134-44.

235. The Montana Supreme Court, for example, has been hesitant to find negligence in administration of a loan. *See* First Nat'l Bank v. McGuiness, ____ Mont. ____, ____, 705 P.2d 579, 586 (1985).

such as the bank in *Jacques*, should be different from the duty of the bank that considers renewing credit to a borrower in default. In the former case, it is reasonable for the borrower to expect certain standards to be followed and in the latter case it is only reasonable for the borrower to expect that the lender will do what it can legally do to get out of a bad situation, which is often used to initiate a foreclosure action.

2. *Tort of Breach of Implied Covenant of Good Faith and Fair Dealing*

As discussed, the implied covenant of good faith and fair dealing standard should be applied to the lender's actions. The extent of the covenant should be measured by the justifiable expectations of the parties. This section argues, however, that the implied covenant should not be applied to the actual decision to extend further credit to a delinquent borrower because the parties usually do not expect the covenant to be applied. The Montana Supreme Court in *Nicholson v. United Pacific Insurance Co.*[236] held that the "implied covenant of good faith and fair dealing is measured by the justifiable expectations of the parties" and "if a party acts 'arbitrarily, capriciously or unreasonably,' that conduct exceeds the justifiable expectations of the second party" resulting in tort liability.[237] Shortly after the *Nicholsen* case was decided, the court implied that the covenant of good faith and fair dealing would not be implied in all contracts, but would be measured by the justifiable expectation of the parties.[238]

It is proper to imply a "covenant of good faith and fair dealing" to certain aspects of the typical debtor-creditor situation, especially when the borrower is a farmer or other small businessperson.[239] Banks have, as a whole, fostered an image of being "a bank you can trust." If a lender is selected by a farmer or small businessperson because it is "reliable" and "trustworthy," then a covenant of good faith and fair dealing has to be inferred into the contract between the lender and borrower. A further argument can be made for inferring the covenant when there are elements of adhe-

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236. ___ Mont. ___, 710 P.2d 1342 (1985).

237. *Id.* at ___, 710 P.2d at 1348.

238. Thiel v. Johnson, ___ Mont. ___, 711 P.2d 829, 833 (1985) (". . . an implied covenant of good faith and fair dealing is not an obligation arising from a contract (The writer hereof does not agree. . . . I would imply the covenant in every contract)."). *See also Nicholson*, ___ Mont. at ___, 710 P.2d at 1347-48. Likewise, 1987 Mont. Laws ___ (House Bill 592), which describes the conduct required by the implied covenant does not mandate that the covenant is implied in all contracts.

239. *Nicholson*, ___ Mont. at ___, 710 P.2d at 1347.

sion or inequality. Farmers are frequently unable to negotiate most of the terms of the promissory notes, although they are able to dicker over such things as the amount of collateral. Likewise, although farmers are usually sophisticated businesspersons when it comes to raising and selling their product, they are not necessarily sophisticated when it comes to negotiating for credit. Unlike large businesses, farmers frequently do not retain legal counsel when negotiating or closing a loan and do not employ sophisticated chief financial officers.

The nature and extent of the covenant in debtor/creditor contracts must be determined by the justifiable expectations of the parties.[240] With respect to credit decisions, it is clearly not reasonable to expect the lender to extend further credit if there is insufficient collateral to support the loan or if the lender doubts the farmer's ability to repay the loan. Borrowers who are delinquent with loan repayments ought not be able to claim that they reasonably believed that the lender would extend a loan to undercollateralized debtors or debtors who are in default.

Borrowers can have no more justifiable expectation than to expect that the lender will make the credit decision in accordance with its standards at the time the credit decision is to be made. Because of the nature of lending standards, the standards should not be measured against an objective reasonable lending standard. Banks' lending standards are to a large extent controlled by state and federal regulation,[241] and by policies of corresponding lenders and the Farm Credit System.[242] Since borrowers can expect nothing more than for the lender to make credit decisions based on their subjective belief as to whether or not the loan is a sound investment for the lender, with respect to the credit decision itself, the decision to extend further credit is not best tested under an objective good faith standard. Rather, the conduct should be measured by contract and fraud theories.[243] But, while the borrower may not reasonably expect the credit decision to be made on any

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240. The precise nature and extent of this covenant is not absolutely clear under Montana law. *See* Darko v. United States Dep't of Agric., 646 F. Supp. 223, 225 (D. Mont. 1986). Some certainty, however, has been added by 1987 Mont. Laws ____. The statute, however, does not define precisely what commercially reasonable conduct is.

241. *See, e.g.*, MONT. CODE ANN. § 32-1-431 (1985) (limitations on real estate loans), MONT. CODE ANN. § 32-1-432 (1985) (limitation on loans) and MONT. CODE ANN. § 32-1-455 (1985) (reserve requirements).

242. Small rural banks are frequently not able to make loans as large as the farmer requires. Those banks establish a relationship with larger banks and the Farm Credit System. M. BOEHLJE & V. EIDMAN, FARM MANAGEMENT at 619 (1984).

243. For example, if the lender contracts to extend further credit or fraudulently represents the intent to do so.

other basis than the lender's belief about the soundness of the loan, the borrower may reasonably expect that the decision will be communicated and implemented in a reasonable, non-arbitrary way. If a decision is made to sever credit, it is reasonable to expect that the debtor will be notified within a reasonable time and, in some cases, will be given a reasonable time to replace the credit with credit from another source.

IV. Conclusion

When courts are asked to determine whether a lender is liable for damages for an unexpected termination of credit, courts must use care in analyzing a claim that does not fit neatly into any cause of action. If the due date of a note has been fixed by agreement and the loan is in default due to non-payment, lenders should not be liable for making the business judgment, in good faith, to exercise their collection rights under the agreement.