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by

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Reducing Excessive and Unjustified Awards In Lender Liability Cases

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The law of lender liability is aimed at redressing injuries caused to a borrower by its lender.[1] Although there has been massive growth in the number of cases alleging lender liability over the past 10 years or so,[2] it is hardly a new phenomenon.[3] One of the main reasons for the growth of lender liability has been the courts' willingness to apply a variety of tort theories to lending relationships at the behest of creative borrowers and their counsel — usually advanced as counterclaims or affirmative defenses to lenders' lawsuits on defaulted obligations.[4] In the paradigm lender

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1. For purposes of this article, the term "lender" will refer to lending institutions, banks, savings and loan associations, equity lenders, investment vehicles, and individuals. Generally, however, the article is directed toward the liabilities of lending institutions.

2. Kenneth L. Howe, *Failing Businesses Dragging Banks To The Courtroom*, SAN FRANCISCO BUS. J., Sep. 22, 1986, at 1; L.A. Hughes, *Small Banks Fear Spread of Lender Liability Suits*, S. FLA. BUS. J., Aug. 10, 1987, at 25; *Rash of Lender Liability Suits Seen Peaking As Lenders Adjust*, BNA'S BANKING REP., Aug. 17, 1987, at 310; Kirk Victor, *Lender Liability Doctrine Gives Creditors Clout; Suing the Bankers*, NAT'L L.J., Sep. 1, 1986, at 1; *IBAA Urges Support For Legislative Solution To Lender Liability Problem*, PR Newswire, June 18, 1991, *available in* LEXIS, Nexis Library, Wires File; Herbert Swartz, *New Business Trend: If Loan Goes Bad, Sue Your Banker*, NEW ORLEANS BUS., May 26, 1986, at 1A.

3. *See, e.g.*, Stewart v. Phoenix Nat'l Bank, 64 P.2d 101 (Ariz. 1937); Earl Park State Bank v. Lowmon, 161 N.E. 675 (Ind. App. 1928).

4. The following tort theories are most often used by plaintiffs to hold lenders accountable for actions that may or may not be contractually justified: (1) breach of fiduciary duty (Whitney v. Citibank, 782 F.2d 1106 (2d Cir. 1986)); (2) breach of the duty of good faith and fair dealing (K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985); Sterling Faucet Co. v. First Municipal Leasing Corp., 716 F.2d 543 (8th Cir. 1983); Commercial Cotton Co. v. United Calif. Bank, 209 Cal. Rptr. 551 (Cal. Ct. App. 1985); Tribby v. Northwestern Bank, 704 P.2d 409 (Mont. 1985); First Nat'l Bank v. Twombly, 689 P.2d 1226 (Mont. 1984); Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 686 P.2d 1158 (Cal. 1984); Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983)); (3) actual fraud (General Motors Acceptance Corp. v. Central Nat'l Bank, 773 F.2d 771 (7th Cir. 1985); Sanchez-Corea v. Bank of America, 701 P.2d 826 (Cal. 1985); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661 (Tex. Ct. App. 1984)); (4) constructive fraud (Central States Stamping Co. v. Terminal Equip. Co., 727 F.2d 1405 (6th Cir. 1984); Deist v. Wachholz, 678 P.2d 188 (Mont. 1984);

liability case, the borrower claims that the lender misled the borrower about its intention to declare a default,[5] that the lender promised to provide future financing that was never in fact provided,[6] or that the lender misrepresented the borrower's financial condition to a third party.[7] Disgruntled borrowers base their claims on theories such as fraud, negligent misrepresentation, and tortious interference with contractual or business relations. These "extra-contractual" theories increase damage award amounts by changing the methods of establishing and calculating damages.[8] The purpose of this article is not to discuss these theories or their development, as this has been done adequately elsewhere.[9] Rather, this article concedes (for the sake of argument) the validity of the theories and will examine the damage aspect of litigation based upon these theories.[10]

Barrett v. Bank of America, 229 Cal. Rptr. 16 (Cal. Ct. App. 1986)); (5) duress (Pecos Constr. Co. v. Mortgage Investment Co., 459 P.2d 842 (N.M. 1969)); and (6) negligent misrepresentation (Melamed v. Lake County Nat'l Bank, 727 F.2d 1399 (6th Cir. 1984)).

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

6. *See, e.g.*, Sanchez-Corea v. Bank of America, 701 P.2d 826 (Cal. 1985).

7. *See, e.g.*, General Motor Acceptance Corp. v. Central Nat'l Bank, 773 F.2d 771 (7th Cir. 1985).

8. For example, in K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985), the Sixth Circuit affirmed a jury award of $7,500,000 based upon a lender's refusal to advance additional funds, even though the loan agreement specifically and unequivocally granted the lender the sole and unfettered discretion to refuse further advances. In Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983), the Supreme Court of Alaska allowed compensatory and punitive damages based upon the lender's taking possession of collateral without notice — despite the fact that the contract clearly authorized such repossession. *See also* Commercial Cotton Co. v. United Calif. Bank, 209 Cal. Rptr. 551 (Cal. Ct. App. 1985) (tort damages justified based upon "special relationship" between lenders and borrowers); First Nat'l Bank v. Twombly, 689 P.2d 1226 (Mont. 1984).

See also Charles M. Louderback and Thomas W. Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F.L. REV. 187, 205 (1982). It has also been suggested that one result of the application of extracontractual theories to a lender liability context is the undermining of the efficiency of capital markets. *See* James R. Borders, Note, *The Growth of Lender Liability: An Economic Perspective*, 21 GA. L. REV. 723, 742-54 (1987).

9. Melissa Cassedy, Note, *The Doctrine of Lender Liability*, 40 FLA. L. REV. 165 (1988); Troy H. Gott & William L. Townsley, Note, *Lender Liability: A Survey of Theories, Thoughts and Trends*, 28 WASHBURN L.J. 238 (1988); John O. Tyler, Jr., *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411 (1987); Werner F. Ebke & James R. Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 SW. L.J. 775 (1986); Lawrence F. Flick & Dennis Replansky, *Liability of Banks to Their Borrowers: Pitfalls & Protections*, 103 BANKING L.J. 220 (1986); Edward L. Symons, *The Bank-Customer Relation: Part I — The Relevance of Contract Doctrine*, 100 BANKING L.J. 220 (1983); Edward L. Symons, *The Bank-Customer Relation: Part II — The Judicial Decisions*, 100 BANKING L.J. 325 (1983).

10. Professor Daniel R. Fischel has suggested that if the economics of lender-borrower relationships were properly understood, there would be no issue when it comes to damages. Nevertheless, Fischel seems resigned to the fact that there are in fact unresolved issues with regard to damages in lender liability cases, and that they are "in serious need of attention." Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 133, 147 (1989).

Damages in lender liability cases are often quite high.[11] For example, in *Federal Deposit Insurance Corp. v. Scharenberg*,[12] defendant Continental Illinois was found liable for improperly refusing to lend $3 million to a borrowing real estate developer. The plaintiff had requested $105 million in compensatory damages and $200 million in punitive damages. Ultimately, the jury awarded compensatory damages in the amount requested.[13]

How does a judge or jury determine that a bank failing to make a $3 million loan should be responsible to the offended borrower to the tune of $105 million? More importantly, what can lenders and their counsel do to reduce the likelihood of such awards? In order to answer these questions, we must begin with an inquiry into the methods and theories of calculating damages in lender liability cases.

I. Contract Theories of Damage

An analysis of what damages should be available when a borrower is mistreated by a lender should begin with the realization that loan agreements, and hence lending relationships, are nothing more than commercial contracts. In their seminal article on contract damages, Professors Fuller and Perdue identified three purposes for the award of damages when a contract is breached.[14] The first theory assumes that the breaching party has gained some benefit as a result of the breach, and the remedy is to make the breaching party disgorge the benefit received.[15]

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11. Between 1979 and 1989, borrowers were awarded about $1 billion from their lenders. Gail Appleson, *Borrowers Go After Lenders in Burgeoning Area of Law*, REUTER BUS. REP., Oct. 2, 1989. It has been speculated that one of the reasons for large awards is that juries inherently dislike banks. *Id.* In 1987, six of the ten highest jury awards involved lender liability suits, all exceeding $50 million. Richard C. Tufaro and J. Huntley Palmer, *The Measure of Damages in Lender Liability Actions*, *in* LENDER LIABILITY LITIGATION 1988, at 679, 681 (PLI 1988) [hereinafter Tufaro & Palmer].

12. No. 84-2712-CIV-DAVIS; No. 87-0211-CIV-DAVIS; No. 87-0238-CIV-DAVIS (S.D. Fla. April 29, 1987).

13. For examples of other large damage awards against lenders, see Conlan v. Wells Fargo, No. 82852 (Cal. App. Dep't Super. Ct. June 10, 1987) (jury award to borrower of $10 million in compensatory damages and $50 million in punitive damages); Jewell v. Bank of America, No. 112439 (Cal. App. Dep't Super. Ct. 1986) (jury award of $19 million in compensatory damages and $27 million in punitive damages); Penthouse Int'l v. Dominion Fed. Sav. & Loan Ass'n, 665 F. Supp. 301 (S.D.N.Y. 1987) (court in bench trial awarded $130 million), *rev'd*, 855 F.2d 963 (2d Cir. 1988), *cert. denied*, 189 S. Ct. 1639 (1989); Robinson v. McAllen State Bank, No. C-1948-84-D (Tex. Dist. Ct. 1987) (verdict of $10 million in compensatory damages and $50 million in punitive damages).

14. L.L. Fuller and William R. Perdue, *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 53-54 (1936). The three theories of Fuller and Perdue form the basis of the RESTATEMENT (SECOND) OF CONTRACTS' damages rules. *See* RESTATEMENT (SECOND) OF CONTRACTS § 344 (1979).

15. Fuller & Perdue, *supra* note 14, at 54.

This is referred to as the restitution interest.[16] The second theory is applied when the nonbreaching party has relied to its detriment on the promise of the breaching party.[17] This is called the reliance interest, and the object is to undo any harm resulting from the nonbreaching party's reliance.[18] The final theory is geared toward giving the promisee the benefit expected or, in other words, putting the nonbreaching party in the same position that he or she would have been in had the contract been performed as promised.[19] This is referred to as the expectation interest.[20]

The restitution theory is not likely to be applied in many lender liability cases.[21] When lenders breach contracts with borrowers, it is usually because they want to cut their losses, not to gain some benefit at the expense of the borrower. In other words, in many lender liability cases the lender is already facing a net loss when it misbehaves. Hence, there is nothing that can be "disgorged" to the borrower.

Contract damages in lender liability cases, therefore, will generally be based upon the remaining two theories: reliance and expectation. Of the two, expectation is the more difficult to determine and the more dangerous from the lender's viewpoint[22] because it seeks to compensate the borrower for something that cannot be known with certainty.[23] Reliance damages are easier to quantify, but questions remain as to why they should be recovered in the first place. The lending of money in and of itself does not create wealth. If a borrower arranges for $100 in financing and does not get it, the borrower is not out-of-pocket $100. It may be difficult, therefore, to

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. Fuller & Perdue, *supra* note 14, at 54. *See also* Walters v. Marathon Oil Co., 642 F.2d 1098 (7th Cir. 1981); Signal Hill Aviation Co. v. Stroppe, 158 Cal. Rptr. 178 (Cal. Ct. App. 1979); Chrysler Corp. v. Quimby, 144 A.2d 123 (Del. 1958).

21. For a further discussion of the restitution theory, see E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339 (1985).

22. Many commentators have suggested that protection of the reliance interest should be the primary goal of contract law. *See* Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentations*, 15 HOFSTRA L. REV. 443 (1987); Mary E. Becker, *Promissory Estoppel Damages*, 16 HOFSTRA L. REV. 131 (1987); Richard Bronaugh, *Lost Opportunities in Contract Damages*, 17 VAL. U. L. REV. 735 (1983); Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. CHI. L. REV. 903 (1985); Jay M. Feinman, *The Meaning of Reliance: A Historical Perspective*, 1984 WIS. L. REV. 1373 (1984); Charles L. Knapp, *Reliance in the Revised Restatement: The Proliferation of Promissory Estoppel*, 81 COLUM. L. REV. 52 (1981); Michael B. Metzger & Michael J. Phillips, *Promissory Estoppel and the Evolution of Contract Law*, 18 AM. BUS. L.J. 139 (1980).

23. *See* John Leubsdorf, *Remedies For Uncertainty*, 61 B.U. L. REV. 132 (1981).

see how the borrower could recover more than the $100 it was wrongfully denied.[24] However, many lender liability cases are in fact brought by borrowers who claim they are worse off than they were before engaging in a relationship with their lenders.[25]

A. *Undoing The Harm: Reliance Damages*

Where a borrower has actually relied upon the lender's promises and suffered some damage *as a result of the reliance*, the borrower is entitled to greater relief than the borrower who merely failed to get what it expected.

> [T]he promisee who has actually relied on the promise, even though he may not thereby have enriched the promisor, certainly presents a more pressing case for relief than the promisee who merely demands satisfaction for his disappointment in not getting what was promised him. In passing from compensation for change of position to compensation for loss of expectancy we pass, to use Aristotle's terms again, from the realm of corrective justice to that of distributive justice.[26]

Some jurisdictions refer to what is called an "out-of-pocket" measure of damages, based purely upon the extent of the borrower's reliance.[27] The "out-of-pocket" theory *reduces*, rather than expands, the amount of recoverable damages because it essentially denies the borrower consequential and puntive damages.

For example, in *Banker's Trust Co. v. Steenburn*,[28] the New York Court of Appeals held that the borrower could recover its out-of-pocket expenses incurred in reliance upon the lender's misrepresentation, but not its lost profits. Recovery of damages beyond one's out-of-pocket costs may therefore require either the expectation theory of damage calculation or a statutory expansion of recoverable damages.[29] For example, California has statutorily provided that a borrower may recover both out-of-pocket

24. *See* Fischel, *supra* note 10, at 133.

25. In other words, Fischel bases his remarks on a refusal of a lender to extend credit. While this is certainly one of the most prevalent lender liability situations, there are others as well, including situations where the lender takes an active role in the running of the borrower's business. *See, e.g.*, Kenneth M. Lodge, et al., *A Lender's Liability For Agent Misdeeds*, 33 SANTA CLARA L. REV. (forthcoming 1993); Kenneth M. Lodge & Thomas J. Cunningham, *The Banker as Inadvertent Fiduciary: Beware the Borrower's Special Trust & Confidence*, COM. L.J. (forthcoming 1993).

26. Fuller and Perdue, *supra* note 14, at 56.

27. Tufaro and Palmer, *supra* note 11, at 686.

28. 409 N.Y.S.2d 51 (1978).

29. *See generally* Robert E. Hudec, *Restating the "Reliance Interest"*, 67 CORNELL L. REV. 704 (1982); Paul T. Wangerin, *Damages for Reliance Across the Spectrum of Law: Of Blind Men and Legal Elephants*, 72 IOWA L. REV. 47 (1986).

expenses incurred as a result of reliance on a lender's misrepresentation and lost profits.[30]

At first blush, putting the borrower back in the position it would have occupied had the borrower and lender never met seems simple. Nevertheless, things can get quite complicated when examined more closely. As Fuller and Perdue have recognized, lost opportunities are an important form of reliance damages.[31] That is, if the borrower relied on the lender's promise to fund a loan and the lender breached its promise, the borrower should recover not only for its out-of-pocket losses,[32] but also for whatever opportunities it passed up as a result of relying on the lender's promise.[33]

The losses resulting from missed opportunities are losses the borrower expected to incur regardless of whether the lender fully performed.[34] The borrower merely hoped that the gains that would result from the lender's performance would exceed the sum of its lost opportunities.[35] In this sense, reliance damages look a lot like expectation damages, at least in lender liability cases. Generally, the difference between expectation and reliance damages is "the difference in value to the plaintiff of (1) the contract he formed with the defendant and (2) the alternative contract (if any) the plaintiff would have formed with someone else had he not contracted with the defendant."[36]

In a lender liability context, if the borrower would have obtained financing from another lender at the *same* rate of interest, the borrower has suffered no reliance damage absent special circumstances. If the borrower could have obtained a *better* rate of interest elsewhere, it presumably would have done so in the first place.[37] If the borrower obtains alternate

30. CALIF. CIVIL CODE § 3343 (West 1970 & 1993 Supp.). *See* Hartman v. Shell Oil Co., 137 Cal. Rptr. 244 (Cal. Ct. App. 1977). *But see* Hartwell Corp. v. Bumb, 345 F.2d 453 (9th Cir. 1965) (although out-of-pocket expense is the correct measure under California law, under the circumstances, the benefit of the bargain approach would be the more accurate measure).

31. Fuller and Perdue, *supra* note 14, at 55, 60.

32. The borrower would not likely have very much of an "out-of-pocket" loss - perhaps a loan application fee, a cost for doing an appraisal of collateral.

33. Fuller and Perdue, *supra* note 14, at 55, 60; Robert Cooter and Melvin Aron Eisenberg, *Damages For Breach of Contract*, 73 CAL. L. REV. 1432, 1440-41 (1985); Melvin Aron Eisenberg, *The Bargain Principle and its Limits*, 95 HARV. L. REV. 741, 744 n.10 (1982); Charles J. Goetz and Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1269 (1980). *See also* Dialist Co. v. Pulford, 399 A.2d 1374 (Md. Ct. App. 1979).

34. *See* Kinzley v. United States, 661 F.2d 187, 193 (Ct. Cl. 1981).

35. Mark Pettit, *Private Advantage and Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages*, 38 HASTINGS L.J. 417, 421 (1987).

36. *Id.* at 422.

37. "Credit markets are intensely competitive; alternative sources of credit abound." Fischel, *supra* note 10, at 136.

financing at a *worse* rate, the borrower simply recovers the difference between the rates.[38] When looked at this way, reliance damages end up being the same as expectation damages. The borrower has passed up the opportunity to obtain financing from a non-breaching lender, but at the cost of paying a higher interest rate. If we deduct the value of the higher rate from the value of the lower rate actually obtained, we arrive at a value equal to the benefit of the borrower's bargain — which is equal to the value of the borrower's reliance on the lender's promise to provide funds at a lower rate. That is, if the borrower had obtained the financing from another lender, and we assume that the alternate lender would not have breached, then the borrower's reliance damages are the lost benefits of the bargain — expectation damages.[39]

B. Benefit of the Bargain: Expectation Damages

Most courts will apply the "benefit of the bargain" analysis to the measurement of damages in a breach of contract case.[40] The goal is to

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38. *See, e.g.*, Financial Fed. Sav. & Loan Ass'n v. Continental Enters., Inc., 338 So.2d 907, 908 (Fla. Dist. Ct. App. 1976) (damage properly measured by additional interest cost of substitute loan, but increased payments to be made in future had to be discounted to present value); First Miss. Bank v. Latch, 433 So.2d 946, 951 (Miss. 1983) (recovery of plaintiff borrower limited to difference between agreed upon interest rate and rate paid to secure funds committed to by lender, but not disbursed); Consolidated Am. Life Ins. Co. v. Covington, 297 So.2d 894, 898 (Miss. 1974) (borrowers who had to obtain money elsewhere after lender's breach were entitled to additional interest they had to pay and attorney's fee required to secure new loan); Eaton v. Danziger, 246 N.Y.S. 98 (1930) (plaintiff entitled to recover excess of legal rate of interest over rate promised to pay lender; however, no excess proven and plaintiff awarded 6 cents nominal damages); Allied Silk Mfrs., Inc. v. Erstein, 186 N.Y.S. 295, 296 (1921) ("If it had obtained another factor, the difference in cost to it between such agreement and the cost under defendants' agreement, for the duration of the latter contract, would have been the measure of damage."); Pipkin v. Thomas & Hill, Inc., 258 S.E.2d 778, 787 (N.C. 1979) (when contract to make loan is breached, borrower is entitled to "[d]ifferential between cost of obtaining new financing and the interest payments specified in the contract").

39. This has been referred to as a "tort/contract hybrid":

> [T]o the extent it takes into account other, forgone opportunities which were available to the relying party, full protection of the reliance interest can be seen as a kind of tort/contract hybrid, attempting to put plaintiff not merely in the position he or she formerly occupied, but in the position that he or she would have attained were it not for the reliance in question.

CHARLES L. KNAPP, COMMERCIAL DAMAGES: A GUIDE TO REMEDIES IN BUSINESS LITIGATION ¶ 2.01 at 2-4 (1991) [hereinafter "KNAPP"].

Despite the conclusion that in lender liability cases reliance damages and expectation damages end up being the same, lenders would be wise to argue that the court should apply a reliance rationale to the calculation of damages. Reliance damages are more difficult to prove — both the act of reliance itself, as well as the measurement of reliance. *See* Cooter and Eisenberg, *supra* note 33, at 1461. On the other hand, this may lead to less continuity among the courts and hence undercut the advantages sought by the lending community as a whole.

40. *See* E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145

place the borrower in the same position it expected to have been in had the lender performed.[41] There are two limitations on this theory. First, the borrower may not recover unforeseeable damages.[42] Second, damages cannot be recovered if they could have been avoided by the borrower through reasonable efforts.[43] Both of these limitations are discussed later in this article.[44]

It is important to remember that the expectation principle attempts to place the borrower in the position it *expected* to be in at the time of contracting, not the position it would *actually* have been in had the lender performed.[45] Lenders are thus protected from the burden of compensating borrowers for *all* of the harm caused by their misbehavior.[46] Unfortunately, courts too often try to determine what position the borrower would have been in "but for" the lender's breach, rather than focusing on the parties' expectations.

Trying to determine what *would have* happened leads the court down the primrose path to unreality. As the court seeks to find out what *actually* would have happened and is frustrated, it will turn to what *probably* would have happened. This leads to a comparison of the actual situation at the time of the breach with similar situations where no breach occurred.

> As a court's findings about a violation's effects and the conditions that would have existed absent a violation become less particularized, it becomes less and less realistic to think of the court as seeking to restore the world that would have existed had the law not been violated.

(1970) [hereinafter Farnsworth, *Legal Remedies*].

41. *See* PATRICK S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT (1979). Note that the converse is not true. That is, if the borrower breaches an agreement to borrow a certain sum of money at a certain rate of interest, the lender will not likely be successful in suing the borrower for the difference between the interest rate the borrower would have taken the funds at and the interest rate at which the funds were actually loaned. *See, e.g.*, Lincoln Nat'l Life Ins. Co. v. NCR Corp., 603 F. Supp. 1393 (N.D. Ind. 1984), *aff'd*, 772 F.2d 315 (7th Cir. 1985). *But see* Teachers Ins. & Annuity Ass'n of Am. v. Butler, 626 F. Supp. 1229 (S.D.N.Y. 1986) (plaintiff lender awarded difference between the contracted rate of interest and the prevailing rate of interest during the month after the contemplated loan closing, amortized over the 35 year term of the loan and discounted to present value).

42. *See* Hadley v. Baxendale, 156 Eng. Rep. 145 (QB 1854); Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989). *See also infra* notes 103-34 and accompanying text.

43. *See* Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983).

44. Mitigation is discussed *infra* at notes 51-58 and accompanying text. Foreseeability is common to both contract and tort damages, and is therefore discussed in the section of the article covering the common concepts, *infra* at notes 103-34 and accompanying text.

45. Leubsdorf, *supra* note 23, at 136.

46. WILLIAM PROSSER, HANDBOOK ON THE LAW OF TORTS 250-70 (4th ed. 1971); Farnsworth, *Legal Remedies*, *supra* note 40, at 1203.

> Instead, the court is handing out standardized remedies, somewhat in the nature of insurance payments.[47]

Making awards based upon what usually happens in similar situations has been justified "as a means of encouraging and protecting reliance upon promises."[48] But, the net result is confusion on the part of lenders as to how much risk they face as a consequence of breach. As Judge Posner has pointed out, "it is not the policy of the law to compel adherence to contracts but only to require each party to choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to perform."[49] This policy is frustrated when courts do not determine the known expectations and ability to cover losses and instead apply some standardized "form remedy" based upon what usually happens in similar situations.[50]

The theory of efficient breach as described by Judge Posner provides that if the lender feels insecure about advancing funds as promised, and the borrower can obtain financing elsewhere at a higher rate of interest, the lender may choose to breach the contract and pay the borrower the difference in interest. Should the borrower fail to seek replacement financing, however, and sue the lender claiming that it was unable to complete a project due to the lender's breach, the borrower should not be able to recover more than could have been obtained had it found alternate financing.

Therefore, in awarding damages based upon the expectation theory, courts should focus upon the reasonable expectations that existed when the contract was made, and the ability of the borrower to cover when the lender breaches. For example, let us consider a contractor that plans to build a hotel for a developer who expects the property to be worth $50 million upon completion. The developer needs to borrow $35 million to complete the project. The lender agrees that the project, if completed according to plan, will be worth $50 million and therefore feels safe in lending $35 million. These are the parties' expectations at the outset of the relationship.

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47. Leubsdorf, *supra* note 23, at 149.

48. Farnsworth, *Legal Remedies*, *supra* note 40.

49. RICHARD POSNER, ECONOMIC ANALYSIS OF THE LAW 88 (2d ed. 1977) (citing Oliver Wendell Holmes, *The Path of the Law*, *in* COLLECTED LEGAL PAPERS 167, 175 (1920)).

50. This policy is not without controversy. For example, in *Sutter Home Winery, Inc. v. Vintage Selections*, 971 F.2d 401, 408 (9th Cir. 1992), the Ninth Circuit said that "tort damages are available where restricting recovery to contract damages would 'provide more an incentive for breach of the contract than for its performance.'" (quoting Rawlings v. Apodaca, 726 P.2d 565, 576 (Ariz. 1986) (discussing whether breach of an impled covenant may provide the basis for tort damages)). This theory would seem to imply that a party should not be allowed to breach a contract and pay contract damages merely because it is economically efficient.

Now assume that at some point, the lender refuses to continue funding the loan and breaches the agreement. The market for hotels might make the project worth $60 million if completed, given changes that have occurred since the making of the loan. More likely, the changed conditions would decrease the value of the project, say to $40 million. Regardless, under the expectation theory of damages, the borrower should recover the $15 million difference between the expected value of the completed project and its expected cost, assuming it is unable to cover.

Before the borrower can recover its expectation interest, however, it must attempt to mitigate its damages by seeking alternative financing elsewhere.

C. *Limitations on The Recovery of Contract Damages: Mitigation*

It is a fundamental concept of contract law that nonbreaching parties must attempt to mitigate their damages as much as possible.[51] The failure to do so precludes the injured party from recovering damages for any loss that it could have avoided.[52] Steps to mitigate damages must be taken promptly.[53] The burden is placed on the breaching party to raise the issue of the non-breaching party's failure to mitigate damages.[54]

Borrowers whose lenders refuse to provide promised funds must therefore make reasonable attempts to locate alternative funding[55] in order

51. *See, e.g.*, Advanced Medical v. Arden Medical Systems, 955 F.2d 188, 200 (3d Cir. 1992).

52. E. ALLAN FARNSWORTH, CONTRACTS § 12.12 at 859 (1982) [hereinafter FARNSWORTH].

53. *Id.* at 862.

54. Kensington Rock Island, L.P. v. American Eagle Historic Partners, 921 F.2d 122 (7th Cir. 1990); Stanley Gudyka Sales Co., Inc. v. Lacy Forest Products Co., 915 F.2d 273 (7th Cir. 1990); Allied Int'l, Inc. v. International Longshoremen's Ass'n, 814 F.2d 32 (1st Cir.), *cert. denied*, 484 U.S. 820 (1987); Turner and Boisseau v. Marshall Adjusting Corp., 775 F. Supp. 372 (D. Kan. 1991); Mercer v. Jaffe, Snider, Raitt and Heuer, 730 F. Supp. 74 (W.D. Mich. 1990).

55. *See* KNAPP, *supra* note 39, ¶ 62.03[1] at 62-9 n.8 (citing Golbar Properties, Inc. v. North Am. Mortgage Invs., 78 A.D.2d 504 (1980), *aff'd*, 53 N.Y.2d 856 (1981)) ("burden of proving failure to mitigate or avoid damage is on breaching party; thus, where defendants made no showing that the mortgage held by plaintiff had value, facts indicated that mortgage had no value and the sale of the property would have produced no return and defendant did not meet their burden; plaintiff not required to foreclose on the building to mitigate damages"); Hidalgo Prop., Inc. v. Wachovia Mortgage Co., 617 F.2d 196, 200 (10th Cir. 1980) (aggrieved borrower must make reasonable effort to mitigate or lessen damages; but he need not unreasonably exert himself or incur an unreasonable expense); Pontchartrain State Bank v. Duden, 503 F. Supp. 764, 769 (E.D. La. 1980) (plaintiffs were barred from recovering any damages from alleged wrongful acts of defendant lender since they failed to use all reasonable means to mitigate claimed damages); Sergeant Co. v. Pickett, 401 A.2d 651, 660 (Md. Ct. App. 1979), *aff'd*, 423 A.2d 257 (1981) (borrower must avoid losses claimed by reasonable effort or expense without risk of additional loss or injury); Riverside Park Realty Co. v. FDIC, 465 F. Supp. 305, 315 (M.D. Tenn. 1978) ("The rule requiring an injured party to prevent avoidable consequences of a breach is especially applicable with regard to breaches of contracts to lend money . . . . Damage in such cases is thought to be easily avoidable because the injured party can usually procure the money from other lenders."); Malex Realty Corp. v. Hageman, 201 N.Y.S. 677 (1923)

to recover damages based on the failure to lend. This principle was applied in *Utah Farm Production Credit Ass'n v. Cox.*[56] There, the Utah Supreme Court stated that a borrower "may not, either by action or inaction, aggravate the injury occasioned by the breach, but has a duty to actively mitigate his damages."[57] Thus, a would-be borrower who has been denied promised funds must "actively seek alternate financing."[58]

D. The Appropriateness of Contract Damage Methodology

Relationships between persons are governed by a system of overlapping legal duties. These duties may arise as a matter of law (tort duties) or they may arise as a matter of agreement between the parties (contract duties). Some duties that arise as a matter of law may be intentionally altered by agreement. The question of whether to apply a contract or tort methodology to damage analysis depends upon the duty breached. There is no common law duty that says a lender must provide funds to a borrower. If the lender has failed to provide funds, the borrower may not recover damages unless it can prove that the parties agreed that the lender would do so and that the lender failed to live up to that agreement. On the other hand, there is no need for the parties to expressly agree that the lender will not interfere with the borrower's other contracts. That is a duty that arises as a matter of law and not out of the contract.[59] Thus, if the lender interferes with the borrower's other contracts, the lender has committed a tort and the analysis should focus on tort damage methodology.

It is not uncommon for a borrower and lender to contractually alter the duties imposed upon them as a matter of law. However, in *K.M.C. Co. v. Irving Trust Co.*,[60] the Sixth Circuit limited the effectiveness of such actions, allowing a borrower to recover in tort when it should have been restricted to contract theories. There, the loan agreement allowed the lender to refuse to advance additional funds for any reason. When the bank subsequently refused to make a requested advance, the borrower sued. The

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(where plaintiff failed to avail itself of alternative financing, although available on terms different from those originally bargained for, no damages awarded); Allied Silk Mfgs, Inc. v. Erstein, 186 N.Y.S. 295 (1921) (where plaintiff alleged that it was compelled to discontinue its business because of breach of the defendants' agreement to act as factors and evidence showed that other factors were readily available and plaintiff's lack of diligence was the cause of the failure to obtain substitute financing, only nominal damages ($.06) awarded).

56. 627 P.2d 62 (Utah 1981).

57. *Id.* at 64.

58. Commerce Financial v. Markwest Corp., 806 P.2d 200, 203 (Utah Ct. App. 1990).

59. *See* RESTATEMENT (SECOND) OF TORTS §§ 766, 767 (1979); 45 AM. JUR. 2D *Interference* § 1 (1969).

60. 757 F.2d 752 (6th Cir. 1985).

bank was ultimately held liable for $7.5 million. The Sixth Circuit affirmed, holding that although the contract did not require it, the lender had a legal duty either to advance the funds on demand or to give notice of its intention not to make any more advances.[61] Not all contractual modifications of duties implied-in-law, therefore, will be successful. The *K.M.C.* court justified its result by claiming the ability to modify such duties is limited by a standard of good-faith.[62]

What is more interesting about the *K.M.C.* decision, however, was the court's willingness to uphold a $7.5 million verdict that appears unsubstantiated by the evidence. As the court itself recognized, "the company was heavily leveraged, its heavy losses from 1981 had eroded stockholder equity, and it had a substantial amount of uncollectible receivables in excess of its bad debt reserve."[63] Thus, even if the lender had advanced the requested $800,000, the company may well have failed anyway.

Even if the company would not have failed, how did the jury arrive at the figure of $7.5 million?

> The jury reached this conclusion based on testimony by two of plaintiff's experts, who testified that the value of K.M.C. to potential acquirors was reduced by $10 million or more by Irving's refusal to advance the $800,000 on March 1. This testimony is inherently incredible. Why should the value of K.M.C. fall by more than $10 million because of the lack of availability of funds for three days? During this three day period, K.M.C. had $800,000 less money but it also owed $800,000 less.[64]

In other words, if the business were worth X to potential acquirers before the lender wrongfully withheld the additional funds, it is unlikely that the business was worth X minus $7.5 million just three days later as a result of the failure to loan an additional $800,000.

Damages in *K.M.C.* should have been based upon the expectations of the parties at the time they entered the contract. That is, K.M.C. was entitled to obtain the difference between the interest rate it would have paid Irving and the "cover" interest rate it would have had to obtain when Irving breached. If consequential damages — such as a decrease in the firm's value — occurred (as K.M.C. alleged), then they would also be recoverable if reasonably foreseeable at the time the contract was made. The court did not purport to apply a contract methodology of damages, however, but

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61. *Id.* at 759.
62. *Id.* at 761-63.
63. *Id.* at 766.
64. Fischel, *supra* note 10, at 153 (citations omitted).

rather appeared to try to compensate K.M.C. for the actual decrease in the value of the firm by allowing expert testimony as to the firm's value prior to the failure to advance funds and immediately after the refusal.[65] Although this attempt to restore the status quo is akin to reliance damages, it is more likely that the court simply treated its theory - bad faith - as a tort. Tort damage calculations are somewhat different than contract damage calculations.

II. Tort Theories of Damage

It has been said that when the damage analysis switches from contract to tort theories, the purpose of a remedy is no longer to protect the borrower's expectation, but is rather to restore the status quo.[66] Tort theories thus approximate the goal of reliance damages discussed above.[67] However, tort theories allow easier access to consequential damages than contract theories, and thus may compensate the borrower in an amount greater than that necessary to restore the status quo.[68] A plaintiff may recover a more expansive range of damages in tort actions than in contract actions, as tort damages are based upon the concept of fault.[69] In some cases, however, a plaintiff's tort damages may be limited to the amount of recoverable contract damages.[70] In addition, courts have historically demanded stricter proof of contract damages, although this requirement has

65. *K.M.C.*, 757 F.2d at 766.

66. ROBERT S. THOMPSON AND JOHN A. SEBERT, REMEDIES: DAMAGES, EQUITY AND RESTITUTION § 2.01 at 2-7, Note 2-4 (1983).

67. *See supra* notes 26-39 & accompanying text.

68. *See infra* notes 67-78 & accompanying text.

69. *See* Timothy J. Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 217-18 (1977). *See also* Onam Alaska v. Bell Lavalin, Inc., 842 P.2d 148 (Alaska 1992). Although it is generally true that damage awards are higher in tort cases than in contract cases, this is not always true. Sometimes a plaintiff will be better off in contract. *See, e.g.*, DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES: CASES AND MATERIALS 35-44 (1985) (comparing Chatlos Sys. v. Nat'l Cash Register, 670 F.2d 1304 (3d Cir. 1982) with Smith v. Bowles, 132 U.S. 125 (1889)).

70. Advanced Medical, Inc. v. Arden Medical Systems, Inc., 955 F.2d 188 (3d Cir. 1992). In *Advanced Medical*, the court considered the issue of what compensatory damages were recoverable for tortious interference with contract. The court stated that absent consequential damages, the plaintiff should recover no more on the tort theory than on a theory of breach of contract. One of the favorite theories of lender liability is tortious interference with contract, so this holding has important implications for lender liability cases. Note that the court was careful to qualify its holding by saying "absent consequential damages." For examples of tortious interference cases in a lender liability context, see State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 688-90 (Tex. Ct. App. 1984); Black Lake Pipe Line Co. v. Union Constr. Co., 538 S.W.2d 80 (Tex. 1976); Davis v. Lewis, 487 S.W.2d 411, 414 (Tex. Ct. App. 1972); Leonard Duckworth, Inc. v. Michael L. Field & Co., 516 F.2d 952 (5th Cir. 1975); Nordic Bank PLC v. Trend Group, Ltd., 619 F. Supp. 542, 560-61 (S.D.N.Y. 1985).

been relaxed in recent years.[71] Finally, when the borrower relies upon tort theories, it may be able to recover punitive damages which are ordinarily not recoverable in contract actions.[72]

Lender liability awards based upon tort theories are often unpredictable because, unlike contract damages, tort damages do not require the element of foreseeability per se.[73] This unpredictability leads to an increase in the cost of borrowing money and in the consequent damage to the economy from the reduced flow of capital.[74] On the other hand, "[i]f only contract damages are allowed then the disabling of market participants will threaten economic stability."[75]

Even when an action sounds in contract, it is likely that a court will allow a tort damage formulation to be used in a lender liability context.[76] It is fundamental that a breach of contract is not a tort, however.[77] Courts should attempt to regain the distinction between contract and tort, and to begin to assess a contract damage methodology in cases involving breaches of agreements to lend money. Only when the lender breaches some duty implied-in-law that has not been modified by agreement should the court apply a tort methodology.[78]

A. Causation

The most important part of tort damage methodology is causation. Causation has been described as both the most "pervasive" concept in tort law, and also the most "elusive."[79] The requirement that the defendant's act actually cause the plaintiff's loss is the first rule of damage calculation

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71. Robert N. Strassfeld, *If . . . : Counterfactuals in the Law*, 60 GEO. WASH. L. REV. 339, 350 (1992) (citing DAN D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 150-57 (1973); FARNSWORTH, *supra* note 52, at 881-88).

72. *See infra* notes 135-66 and accompanying text.

73. 22 AM. JUR. 2D *Damages* § 133 (1988).

74. *See* Brad Schacht, Note, *Bad Faith Lenders*, 60 U. COLO. L. REV. 417, 441 (1989).

75. Ann-Marie Davidow, Note, *Borrowing* Foley v. Interactive Data Corp. *to Finance Lender Liability Claims*, 41 HASTINGS L.J. 1383, 1412 (1990).

76. *See, e.g.*, Seaman's Buying Serv., Inc. v. Standard Oil Co., 686 P.2d 1158 (Cal. 1984); Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141 (Cal. 1979), *appeal dismissed, cert. denied*, 445 U.S. 912 (1980); Commercial Cotton Co. v. United Cal. Bank, 209 Cal. Rptr. 551 (Cal. Ct. App. 1985); Wallis v. Superior Ct., 207 Cal. Rptr. 123 (Cal. Ct. App. 1984).

77. WILLIAM PROSSER, HANDBOOK ON THE LAW OF TORTS 2 (5th ed. 1984).

78. Once again, it is important to protect parties' freedom of contract. Within certain limitations, parties should be free to modify duties implied-in-law. Where those duties have been modified by contract, absent extenuating circumstances a court should not allow a borrower to assert a tort theory based upon the modified duty.

79. Richard W. Wright, *Causation in Tort Law*, 73 CAL. L. REV. 1735, 1737 (1985) (citing OLIVER WENDELL HOLMES, THE COMMON LAW 64 (M. Howe ed. 1963)); PROSSER, *supra* note 46, § 41 at 236-37, 241.

regardless of whether the theory of liability sounds in tort or contract.[80] "In other words, if the plaintiff had no loss, or if he had one, but would have suffered the same loss even in the absence of the defendant's actionable misconduct, he is entitled to no recovery."[81] The main difference between causation in contract methodology and causation in tort methodology is the concept of "proximate cause." While tort defendants may be held liable for all injuries proximately resulting from their actions, under a contract methodology, causation is limited to actual cause.[82]

The first step in determining proximate cause is the establishment of actual cause. In other words, the defendant's conduct must have actually contributed to the plaintiff's injury.[83] A plaintiff's injury is seldom caused solely by a defendant's conduct, however. Rather, the injury may be the result of several contributing factors. Thus, proximate cause requires the court to consider any contributing factors that might "reduce or eliminate, for reasons of policy or principle, the defendant's legal responsibility for harm that was caused by his tortious conduct."[84]

B. Valuation

The second rule of damages is that the plaintiff must be able to prove the *amount* of damages with reasonable certainty.[85] If we exclude consequential damages such as lost opportunities, valuation in a lender liability case using tort theory is simple. In a case like *K.M.C.*, the court would take expert testimony regarding the worth of the business before the borrower and lender met, and would subtract from that value the worth of the business after the lender committed the tort to determine the borrower's loss. If the business has failed entirely, the loss is simply the value of the business at the inception of the lending relationship.

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80. DOBBS, *supra* note 71, at 148.

81. *Id.* at 149.

82. "In tort law's darkest corner lurks the concept of proximate cause." Kenneth Vinson, *Proximate Cause Should Be Barred From Wandering Outside Negligence Law*, 13 FLA. ST. U.L. REV. 215 (1985) [hereinafter Vinson]. On the other hand, Prosser described the concept of causation as one of the "simplest and most obvious" problems in determining tort liability. PROSSER, *supra* note 79, at § 41, at 237. *See also* Mark F. Grady, *Proximate Cause and the Law of Negligence*, 69 IOWA L. REV. 363 (1984); David Morris Phillips, *The Commercial Culpability Scale*, 92 YALE L.J. 228 (1982); Daniel J. Steinbock, et al., *Expert Testimony on Proximate Cause*, 41 VAND. L. REV. 261 (1988).

83. Wright, *supra* note 79, at 1737.

84. *Id.* at 1744 (citing J. FLEMING, THE LAW OF TORTS 171 (6th ed. 1983); Leon Green, *The Causal Relation Issue in Negligence Law*, 60 MICH. L. REV. 543, 548, 557-59, 564 (1962); Glanville Williams, *Causation in the Law*, 1961 CAMBRIDGE L.J. 62, 63-65 (1961)).

85. DOBBS, *supra* note 71, at 148. The degree of certainty required will vary depending upon the nature of the tort and the circumstances. RESTATEMENT (SECOND) OF TORTS § 912 (1979).

When consequential damages are added, however, the concept of valuation becomes more difficult. This is discussed in the next section.[86]

III. Damage Concepts Common To Both Contract and Tort

Several damage theories apply to lender liability cases regardless of whether the underlying theory is contract or tort, although their application may differ depending upon the theory. These concepts include consequential damages, punitive damages, and the ability to recover prejudgment interest.

A. Consequential Damages

One of the most promising ways for a borrower to maximize its recovery in a lender liability suit is by alleging that it has incurred consequential damages due to the lender's inappropriate behavior. Before one can consider whether consequential damages may be recovered, however, it is important to determine what they are. Loan agreements will often refer to "consequential damages," but will rarely define them.[87] Black's Law Dictionary defines "consequential damages" as:

> Such damage, loss or injury as does not flow directly and immediately from the act of the party, but only from some of the consequences or results of such act. Damages which arise from intervention of special circumstances are not ordinarily predictable. Those losses or injuries which are a result of an act but are not direct and immediate. Consequential damages resulting from a seller's breach of contract include any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise, and injury to person or property proximately resulting from any breach of warranty.[88]

The definition of consequential damages may depend in some degree upon the underlying theory advanced. For example, consequential damages in a tort action may be defined in terms of a "natural and ordinary result,"

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86. *See infra* notes 87-134 and accompanying text.

87. Here is a typical "Waiver of Consequential Damages" clause found in loan agreements:

> In no event shall Borrower or Lender be liable to each other for consequential damages, whatever the nature of a breach by Borrower or Lender of their respective obligations under this Agreement or any of the Loan Documents and Borrower, for itself and Affiliated Parties, and Lender hereby waive all claims for consequential damages.

For a discussion of waivers in written loan agreements as a method of limiting liability, see *infra* notes 172-217 and accompanying text.

88. BLACK'S LAW DICTIONARY 390 (6th ed. 1990).

while in a contract action they may be defined in terms of "reason to know."[89] Usually the borrower will want to argue that because of the lender's misbehavior, the borrower has suffered a loss of the profits it would have ultimately gained had the lender not breached its duty (either contract or tort).

1. Lost Profits.—In a typical lender liability case in which a borrower has been improperly denied capital to start a business, the borrower will argue that the lender's improper actions caused the borrower to lose the profits the business would have made had the lender properly funded the loan. However, as Professor Fischel points out:

> Borrowers in lender liability cases typically assert that they were unable to obtain alternative sources of credit. What has not been fully appreciated, however, is the fundamental incompatibility between this claim and the borrower's simultaneous demand for huge damages to make up for lost profits. If a business is really that valuable, market participants would be willing to invest in it — they are leaving money on the table if they don't. Conversely, if nobody is willing to invest, a strong presumption arises that the business was not that valuable in the first place.[90]

Professor Fischel's analysis would seem to preclude the recovery of lost profits in any lender liability case. In reference to *State National Bank v. Farah Manufacturing. Co.*,[91] a case in which the Texas Court of Appeals awarded a borrower its lost profits, Fischel wrote: "[t]he calculation of lost profits by the plaintiff's expert was meaningless. Any study that tries to forecast profitability for the period 1976-77 by analyzing the profitability of sales from 1959-75 (even assuming this projection was done accurately) is inherently suspect."[92] Fischel's comment is directed at the fact that the '59-'75 period as a whole could not be representative of conditions existing in the single year between '76 and '77.

Despite Fischel's protestations, the loss of prospective business and/or reputation are prototypical consequential damages and are awarded in many contract and tort cases.[93] There are, however, two significant restrictions

89. *See* Wagner v. Dan Unfug Motors, Inc. 529 P.2d 656, 660 (Colo. Ct. App. 1974); A.T.S. Laboratories, Inc. v. Cessna Aircraft, 391 N.E.2d 1041, 1046 (Ohio Ct. App. 1978) ("Consequential damages, as used here, means direct damage suffered as a direct and proximate result of defendant's breach of the duties imposed by the warranty implied."). Regardless of the definition employed, the concept of foreseeability is a common thread.

90. Fischel, *supra* note 10, at 148.

91. 678 S.W.2d 661 (Tex. Ct. App. 1984).

92. Fischel, *supra* note 10, at 152.

93. Bay State Lighting Co. v. Voight Lighting Indus., Inc., 224 U.S.P.Q. 708, 712 (D.N.J. 1984)

on the recovery of lost profits.[94] The plaintiff must initially provide the jury with a "reasonable basis" for computing the award.[95] This is what concerned Fischel about the *Farah* case. Second, the plaintiff must show the value of the loss to a reasonable degree of certainty.[96]

The concepts of reasonable calculation and certainty are very similar, as the former is a method of arriving at the latter. Damages must not be based upon speculation, but rather must be well grounded.[97] The certainty with which damages must be proven will depend upon the nature of the tort and the surrounding circumstances.[98] Certainty applies to damages issues in two respects. First, there must be certainty with regard to causation.[99] Second, there must be certainty as to the amount of damages.[100] The former was discussed earlier,[101] while the latter will be discussed in this section.[102]

It is often said that damages need not be proven to a mathematical certainty.[103] Rather, there must be "some competent evidence" upon which to base an award.[104]

Professor James Henderson writes:

> [C]ourts must try to avoid hypothetical "what would have happened if . . .?" questions in the course of resolving tort disputes. When such hypotheticals are addressed in adjudication, attention focuses on events that never occurred and circumstances that never existed. If liability rules require answers to such questions, proof gives way to speculation. Of course, to some extent these questions are unavoidable in connection with such issues as proximate cause and damages. But the verifiability

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(trade secrets case).

94. These restrictions apply only after the borrower has proven "actual cause," a prerequisite to the recovery of any damages. *See, e.g.*, Western Union Tel. Co. v. Hall, 124 U.S. 444 (1888); National Controls Corp. v. National Semiconductor Corp., 833 F.2d 491 (3d Cir. 1987); Gurney Indus., Inc. v. St. Paul Fire & Marine Ins. Co., 467 F.2d 588 (4th Cir. 1972).

95. City of Whittier v. Whittier Fuel and Marine Corp., 577 P.2d 216, 222-24 (Alaska 1978).

96. *See* RESTATEMENT (SECOND) OF CONTRACTS § 352 (1979).

97. *Whittier*, 577 P.2d at 222.

98. RESTATEMENT (SECOND) OF TORTS § 912 (1979).

99. Dowling Supply and Equip., Inc. v. City of Anchorage, 490 P.2d 907, 909-10 (Alaska 1971).

100. 22 AM. JUR. 2D *Damages* § 486 at 567 (1988).

101. *See supra* notes 79-84 and accompanying text.

102. Sometimes this distinction is referred to as the difference between proof of the fact of loss and proof of the amount of loss. *See, e.g.*, Locke v. United States, 283 F.2d 521 (Ct. Cl. 1960) (plaintiff must establish "reasonable probability of damage" prior to establishing a "reasonable basis" of calculating the loss).

103. *See, e.g.*, *Dowling Supply*, 490 P.2d at 909.

104. *Id.* at 909.

> constraint requires that liability rules avoid raising such questions whenever possible.[105]

Trying to determine what profits a failed business would have earned had it not failed is an attempt by courts and juries to learn the unknowable, and should be discouraged.[106]

The Seventh Circuit has held that the profit that would be earned on an unfinished commercial building is too speculative to be recovered.[107] In *Stanish v. Polish Roman Catholic Union*,[108] the court held that the plaintiff could not recover the difference between the mortgage amount and the value of the property as developed had the lender not breached the agreement to lend. The builder in *Stanish* had no "track record" for the court to consider. Furthermore, construction on the project had not even begun. Although the court considered these factors, they are really irrelevant to the question of whether lost profits would be recoverable.

First, *Stanish* cites *St. Paul at Chase Corp. v. Manufacturer's Life Insurance Co.*,[109] which held that even where a project was substantially completed, the potential profits depended upon "so many uncertainties that they cannot form a proper element of damages in a contract action."[110] Second, even though a plaintiff has experience in the type of business being engaged in, a "new business" without a track record of profits will not provide the court with any basis for awarding lost profits. In *Drs. Sellke & Conlon, Ltd. v. Twin Oaks Realty, Inc.*,[111] the Illinois Appellate Court stated that a business must be "established" in order to recover lost profits.[112] There, the plaintiffs were orthodontists who had arranged for office space from the defendant and were delayed by the defendant in moving in. They argued that they lost profits during the two months they were unable to use the new offices, basing their calculations on the average number of new patients acquired each month after the opening. To overcome the difficulty of speculation, the doctors argued that they had

105. James A. Henderson, Jr., *Process Constraints in Tort*, 67 CORNELL L. REV. 901, 914 (1982) (footnotes omitted); James A. Henderson & Aaron D. Twerski, *Doctrinal Collapse in Products Liability: The Empty Shell of Failure to Warn*, 65 N.Y.U. L. REV. 265, 308 (1990); Morris G. Shanker, *A Retreat to Progress: A Proposal to Eliminate Damage Awards for Loss of Business Profits*, 85 COM. L.J. 83, 87 (1980).

106. Shanker, *supra* note 105, at 87-88.

107. Stanish v. Polish Roman Catholic Union, 484 F.2d 713 (7th Cir. 1973).

108. *Id.*

109. 278 A.2d 12 (Md.), *cert. denied*, 404 U.S. 857 (1971).

110. *Stanish*, 484 F.2d at 726 (quoting *Chase*, 278 A.2d at 38).

111. 491 N.E.2d 912 (Ill. App. Ct. 1986).

112. *Id.* at 917.

always been successful in acquiring new patients in the past, and they were successful in acquiring new patients after the new offices opened. Nevertheless, the court denied recovery, stating: "Nor is past success in similar enterprises sufficient, as conditions may vary with each endeavor."[113]

In *Coastland Corp. v. Third National Mortgage Co.*,[114] the Fourth Circuit determined that a new construction project will be considered a new business. That case involved a developer that sued its lender for breach of an oral commitment to provide construction financing for a shopping center. The court held that although the developer had been successful with other projects, this particular project was a new business. The court cited a line of cases that it deemed the "new business line of cases" which held that potential profits could not be recovered for a breach of contract when a new business is contemplated since it could not be rendered reasonably certain that there would have been any profits.[115]

While *Coastland* called an unfinished construction project a new business, there are no specific guidelines for courts to apply in determining whether a business is "new." In *Atomic Fuel Extraction Corp. v. Estate of Slick*,[116] a Texas appeals court stated that to avoid the consequences of being considered a "new business," the plaintiff would have to prove that it was an "established business":

> An established business should be one that is in actual operation long enough to give it permanency and recognition. It should be one that has earned a profit which can reasonably be ascertained and approximated .... Proof of an operation of a business at a loss fails to meet the test.[117]

Later, in *McBrayer v. Teckla, Inc.*,[118] the Fifth Circuit held that even where a business had been in operation for six months at the time the contract to finance was breached, the business was still "unestablished" such that future profits were too speculative to support an award. The precedential significance of that case is dubious, however, since the borrower had been operating at a loss during those six months and was attempting to sell a new and innovative product.

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113. *Id.* (citing Favar v. Riverview Park, 144 Ill. App. 86, 91 (1908)).

114. Coastland Corp. v. Third Nat'l Mtg. Co., 611 F.2d 969, 977-78 (4th Cir. 1979).

115. *Id.* at 977. The court cited the following cases: Kay Advertising Co. v. Olde London Transp. Co., 217 S.E.2d 876, 878 (Va. 1975); Mullen v. Brantley, 195 S.E.2d 696, 699-700 (Va. 1973); Pennsylvania State Shopping Plazas, Inc. v. Olive, 120 S.E.2d 372, 377 (Va. 1961); Sinclair Refining Co. v. Hamilton & Dotson, 178 S.E. 777, 780 (Va. 1935).

116. 386 S.W.2d 180 (Tex. Civ. App. 1964).

117. *Id.* at 189 (citations omitted).

118. 496 F.2d 122 (5th Cir. 1974).

The "new business rule" is not without its critics.[119] While Virginia has explicitly adopted the rule and allows no recovery of lost profits for a new business,[120] many courts have simply paid lip-service to the rule while creating numerous exceptions.[121] Others simply decline to follow the rule.[122] There are thus two methods of determining whether lost profits are recoverable. "The first approach views the age of the business as one evidentiary factor in determining whether the plaintiff has proven damages with the requisite certainty. The second approach holds that lost profits of a new business are never recoverable because they are inherently speculative."[123] Even courts applying the first approach, however, recognize that proof of lost profits of a new business must satisfy a high standard of proof.[124]

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119. For a good discussion of the "new business rule," see 25 C.J.S. *Damages* §§ 18-31 (1966 & Supp. 1993); 22 AM. JUR. 2D *Damages*, §§ 624-47, 887 (1988 & Supp. 1993), Annotation, *Recovery of Anticipated Lost Profits of New Business: Post-1965 Cases*, 55 A.L.R.4th 507 (1987); Bernadette J. Bollas, Note, *The New Business Rule and the Denial of Lost Profits*, 48 OHIO ST. L.J. 855 (1987); Regina M. Shields, Note, *Commercial Law: Consequential Damages and Loss of Profits of a New Business*, 14 CREIGHTON L. REV. 182, 201 (1980) (discussing *Alliance Tractor & Implement Co. v. Lukens Tool & Die Co.*, 281 N.W.2d 778 (Neb. 1979), which upheld an award for future profits of a new business).

120. Kay Advertising v. Olde London Transp. Co., 217 S.E.2d 876 (Va. 1975); Note, *Lost Profits For Unestablished Business: Should Virginia Retain the New Business Rule?*, 67 VA. L. REV. 431 (1981). Other states have not adopted the rule per se, but have traditionally not allowed recovery of lost profits for new businesses. *See, e.g.*, Paul O'Leary Lumber Corp. v. Mill Equip., Inc., 448 F.2d 536 (5th Cir. 1971); Taylor v. Shoemaker, 38 So.2d 895 (Ala. Ct. App.), *cert. denied*, 38 So.2d 900 (Ala. 1949); Re v. Gannett Co., 480 A.2d 662 (Del. Super. Ct. 1984), *aff'd*, 496 A.2d 553 (Del. 1985) (en banc); Anderson v. Abernathy, 339 S.W.2d 817 (Mo. 1960); Burge Ice Machine Co. v. Strother, 273 S.W.2d 479 (Tenn. 1954); Atomic Fuel Extraction Corp. v. Estate of Slick, 386 S.W.2d 180 (Tex. Civ. App. 1964); Sam & Mary Housing Corp. v. Jo/Sal Market Corp., 468 N.Y.S.2d 294 (1983), *modified on other grounds*, 474 N.Y.S.2d 786, *aff'd on mem. below*, 440 N.Y.S.2d 185.

121. *See, e.g.*, Olivetti Corp. v. Ames Bus. Sys., Inc., 344 S.E.2d 82 (N.C. Ct. App. 1986).

122. *See* Jeffry R. Gilbert, Note, *A New or Untried Business May Recover Lost Future Profits as Damages for Breach of Contract to Lend Money, Provided Such Profits Can Be Established with Reasonable Certainty* — Harsha v. State Savings Bank, 34 DRAKE L. REV. 569 (1984-85). *See also* Systems Corp. v. American Tel. & Tel. Co., 60 F.R.D. 692 (S.D.N.Y. 1973); Vickers v. Wichita State University, 518 P.2d 512 (Kan. 1974); Fera v. Village Plaza, Inc. 242 N.W.2d 372 (Mich. 1976); El Fredo Pizza, Inc. v. Roto-Flex Oven Co., 261 N.W.2d 358 (Neb. 1978); Merion Spring Co. v. Muelles Hnos. Garcia Torres, S.A., 462 A.2d 686 (Pa. Super. Ct. 1983).

123. Note, *Lost Profits For Unestablished Business: Should Virginia Retain the New Business Rule?*, 67 VA. L. REV. 431 (1981) (concluding that it should). Examples of cases following the first approach are Colorado Coal Furnace Distrib., Inc. v. Prill Mfg. Co., 605 F.2d 499 (10th Cir. 1979); Handi Caddy, Inc. v. American Home Prods. Corp., 557 F.2d 136 (8th Cir. 1977); Lee v. Joseph E. Seagram & Sons, 552 F.2d 447 (2d Cir 1977); S. Jon Kreedman & Co. v. Meyer Bros. Parking-W. Corp., 130 Cal. Rptr. 41 (Cal. Ct. App. 1976); John D. Copanos & Sons v. McDade Rigging & Steel Erection Co., 403 A.2d 402 (Md. Ct. App. 1979); Fera v. Village Plaza, Inc., 242 N.W.2d 372 (Mich. 1976); El Fredo Pizza, Inc. v. Roto-Flex Oven Co., 261 N.W.2d 358 (Neb. 1978). *Cf.*, Gold Rush Investments, Inc. v. G.E. Johnson Constr. Co., 807 P.2d 1169 (Colo. Ct. App. 1990).

124. *See, e.g.*, Handi Caddy, Inc. v. American Home Prod. Corp., 557 F.2d 136 (8th Cir. 1977); Engle v. Oroville, 47 Cal. Rptr. 630 (Cal. Ct. App. 1965).

Another interesting issue in considering recoverability of lost profits is whether the requisite degree of certainty depends upon whether the cause of action sounds in contract or tort. There is authority for the proposition that the recovery of lost profits is easier in tort and is not subject to the foreseeability limitations of contract cases.[125] Indeed, all of the cases discussed earlier involved tort actions. "When cases involving breach of contract are compared to tort cases, it appears that less concern is shown in the latter toward the certainty of the evidence supporting damages."[126]

It is instructive to consider the case of *Lincoln National Life Insurance Co. v. NCR Corp.*,[127] where the traditional litigation roles were reversed. The plaintiff was a bank which claimed that the borrower simply refused to take the money it was entitled to under their loan agreement, causing the bank to lose profits. The court found that money is fungible, and that the lender was unable to prove that it "lost" profits by not loaning a certain amount of its available cash to the borrower. In other words, it is possible that the money that would have been lent to the borrower was actually lent or invested in other projects. Thus, the bank was unable to demonstrate that it had in fact lost any profits.

The *Lincoln* case is very similar to the analysis Professor Fischel has applied to borrowers. The borrower in almost any lender liability case is in the same position as the lender in the *Lincoln* case. Either the borrower can borrow from someone else and simply recover the difference between the interest rates, or the borrower was not likely to make any profits anyway.

2. *Good Will & Reputation.*—In addition to the monetary profitability of a business, it is generally considered that the good will and reputation of a firm have value. Borrowers will want to recover from their lenders the value of lost or damaged good will and reputation. The problems facing courts presented with such a request are: (1) how to determine whether good will or reputation existed, (2) whether it was damaged or destroyed, (3) if so, whether such damage or destruction was caused by the lender's misbehavior, and (4) if so, what the value of that good will or reputation was and is.

The last issue — valuation — is the most difficult. Courts agree that loss of reputation or good will is legally compensable. "Although intangible (and not easy to prove), good will is nonetheless real."[128]

125. Sellar v. Clelland, 2 Colo. 532, 551 (1875) ("The recovery of consequential damages in actions for tort is not subject to the same limitations that are applied to actions of contracts.").

126. Note, *Damages: Limitations on Recovery of Lost Profits in Indiana*, 31 IND. L.J. 136, 141 (1955).

127. 603 F. Supp. 1393 (N.D. Ind. 1984), *aff'd*, 772 F.2d 315 (7th Cir. 1985).

128. Westric Battery Co. v. Standard Elec. Co., 522 F.2d 986, 987 (10th Cir. 1975).

Valuation is a problem, and courts have characteristically dealt with it simply by reducing the standard to make it easier to establish. The Tenth Circuit, for example, has said "[t]he amount cannot and hence need not be proven with absolute precision."[129] The New Jersey District Court found an award for loss of reputation "unproblematic" in *Bay State Lighting v. Voight Lighting Industries*.[130] In many cases, recovery for loss of good will or reputation will be allowed so long as the injury is foreseeable.[131]

Generally, the loss of good will will be recoverable according to the same standards governing recovery of lost profits.[132] However, there are courts that have held that although lost profits may be foreseeable and capable of being proven to a reasonable degree of certainty, lost good will is unforeseeable and too speculative to support an award.[133] Presumably, a borrower would still be able to recover for lost good will in these jurisdictions, but would be forced to prove both the fact and value of the loss to a greater extent than is required for lost profits. At least one jurisdiction, Pennsylvania, has taken a step further and placed an outright ban on the recovery of lost good will.[134]

B. Punitive Damages

Punitive (or exemplary) damages are generally not available to a borrower on a contract theory.[135] Some states have codified this

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129. *Id.* at 987, n.2 (citing Kestenbaum v. Falstaff Brewing Corp., 514 F.2d 690 (5th Cir. 1975)); Kobe, Inc. v. Dempsey Pump Co., 198 F.2d 416 (10th Cir.), *cert. denied*, 344 U.S. 837 (1952); H & H Prod. Inc. v. Hughes, 498 P.2d 965 (Colo. Ct. App. 1972)).

130. Bay State Lighting v. Voight Lighting Indus., 224 U.S.P.Q. 708, 712 (D.N.J. 1984).

131. Rite Aid Corp. v. Lake Shore Investors, 471 A.2d 735, 740 and n.9 (Md. Ct. App. 1984) (recovery for damage to reputation a consequential damage as a result of tortious interference with contractual relations) (citing Tose v. First Penn. Bank, N.A., 648 F.2d 879, 898 (3d Cir.)), *cert. denied*, 454 U.S. 893 (1981); Sperry Rand Corp. v. A-T-O, Inc., 447 F.2d 1387, 1392-94 (4th Cir. 1971), *cert. denied*, 405 U.S. 1017 (1972)); Dallman Co. v. Southern Heater Co., 68 Cal. Rptr. 873, 881 (1968).

132. R.E.B., Inc. v. Ralston Purina Co., 525 F.2d 749 (10th Cir. 1975); Hydraform Prods. Corp. v. American Steel, 498 A.2d 339 (N.H. 1985); Adams v. J.I. Case Co., 261 N.E.2d 1 (Ill. App. Ct. 1970).

133. *See, e.g.*, National Controls Corp. v. National Semiconductor Corp., 833 F.2d 491 (3d Cir. 1987); Chrysler Corp. v. E. Shavitz & Sons, 536 F.2d 743 (7th Cir. 1976); Neville Chem. Co. v. Union Carbide Corp., 422 F.2d 1205 (3d Cir.), *cert. denied*, 400 U.S. 826 (1970); Record Club of Am., Inc. v. United Artists Records, Inc., 696 F. Supp. 940 (S.D.N.Y. 1988); Harry Rubin & Sons, Inc. v. Consolidated Pipe Co., 153 A.2d 472 (Pa. 1959).

134. AM/PM Franchise Assoc. v. Atlantic Richfield Co., 542 A.2d 90 (Pa. Super. 1988); Harry Rubin & Sons, Inc. v. Consolidated Pipe Co., 153 A.2d 472 (Pa. 1959).

135. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981); 5 ARTHUR L.CORBIN, CORBIN ON CONTRACTS § 1077, at 438 (1964); KENNETH R. REDDEN, PUNITIVE DAMAGES §§ 4.3 - .3(A) (Cum. Supp. 1986); Leslie E. John, Comment, *Formulating Standards for Awards of Punitive Damages in the Borderland of Contract and Tort*, 74 CALIF. L. REV. 2033 (1986); 25 C.J.S. *Damages*, § 120 at 1126 (1966). *See also* Splitt v. Deltona Corp., 662 F.2d 1142 (5th Cir. 1981); Cochran v. Hall, 8

principle, preventing awards of punitive damages in cases "arising out of contract."[136] Other states have allowed punitive damages in contract cases if the breach is sufficiently outrageous.[137] Punitive damages are definitely recoverable, however, in actions based in tort.[138]

Punitive damages "are assessed for the avowed purpose of visiting a punishment upon the defendant and not as a measure of any loss or detriment of the plaintiff."[139] They are therefore awarded apart from compensatory or special damages and are intended to deter "particularly aggravated misconduct" by the defendant.[140] Often a plaintiff who has the choice of suing on either a tort theory or a contract theory will choose the tort in order to obtain punitive damages.[141]

Some recent decisions have begun to expand the plaintiff's ability to recover punitive damages in an action primarily based upon contract.[142] Over the last 15 years, courts have permitted the recovery of punitive damages in cases involving breach of contract accompanied by fraud,[143] breach of contract accompanied by independently tortious conduct,[144] breach of a fiduciary duty,[145] and breach of the implied covenant of good faith and fair dealing.[146] Any of these exceptions to the general rule

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F.2d 984 (5th Cir. 1925); Phillips Mach. Co. v. Le Blonde, Inc., 494 F. Supp. 318 (N.D. Okla. 1980); Minnesota-Iowa Television Co. v. Watonwan T.V. Improvement Ass'n, 294 N.W.2d 297 (Minn. 1980).

136. *See, e.g.*, CAL. CIV. CODE § 3294 (West 1970 & 1993 Supp.); GA. CODE ANN. § 20-1405 (1989 & Supp. 1992); NEV. REV. STATS. § 42.010 (1987 & 1991 Rev.); S.D. CODIFIED LAWS § 21-3-2 (1987 & 1992 Supp.).

137. Four states have adopted this position: Florida, Indiana, Michigan, and Ohio. Bruce Cameron Bennett, Comment, *Punitive Damages in California Under the Malice Standard: Defining Conscious Disregard*, 57 S. CAL. L. REV. 1065, 1077 n.84 (1984). *See also* REDDEN, *supra* note 135 § 2.6 at 42, JOHN C. MCCARTHY, PUNITIVE DAMAGES IN BAD FAITH CASES § 1.42 at 92 (3rd ed. 1983); David A. Rice, *Exemplary Damages in Private Consumer Actions*, 55 IOWA L. REV. 307, 314 (1969).

138. CHARLES T. MCCORMICK, LAW OF DAMAGES § 77, at 275-76 (1935); WILLIAM PROSSER AND WILLIAM KEETON, THE LAW OF TORTS § 2, at 9 (5th ed. 1984).

139. MCCORMICK, *supra* note 136, § 77 at 275.

140. DOBBS, *supra* note 71, § 3.9 at 204.

141. John, *supra* note 135, at 2034 n.9. It is also true, however, that under certain circumstances the injured party may be better off seeking contractual remedies. *Id.* at n.15 (citing LAYCOCK, *supra* note 69, at 35-44).

142. *See* Randy L. Sassaman, Note, *Punitive Damages in Contract Actions — Are the Exceptions Swallowing the Rule?*, 20 WASHBURN L.J. 86, 93-96 (1980).

143. Powers v. Martinson, 313 N.W.2d 720, 727-28 (N.D. 1981); Peterson v. Culver Educ. Found., 402 N.E.2d 448, 453-57 (Ind. Ct. App. 1980).

144. Hibschman Pontiac, Inc. v. Batchelor, 362 N.E.2d 845, 847 (1977); Brink's Inc. v. City of New York, 717 F.2d 700, 704-05 (2d Cir. 1983).

145. Ramsey v. Culpepper, 738 F.2d 1092, 1099 (10th Cir. 1984); Brown v. Coates, 253 F.2d 36, 39-41 (D.C. Cir. 1958); Capital Fed. Sav. & Loan Ass'n v. Hohman, 682 P.2d 1309, 1310 (Kan. 1984); Mulder v. Mittelstadt, 352 N.W.2d 223, 230 (Wis. Ct. App. 1984).

146. Seaman's Direct Buying Serv. v. Standard Oil Co., 686 P.2d 1158, 1167 (Cal. 1984).

might be applied in a lender liability case. The most often seen example, however, has been the breach of the implied covenant of good faith and fair dealing.

A lender may act in a manner perfectly acceptable under the terms of the agreement, and yet still be found liable for breaching the implied covenant of good faith and fair dealing.[147] Consequently, the lender may be subject to punitive damages. The cases which best exemplify the application of this theory are *Alaska Statebank v. Fairco*,[148] *Commercial Cotton Co. v. United California Bank*,[149] and *First National Bank v. Twombly*.[150]

In *Alaska Statebank*,[151] the loan agreement authorized the lender to accelerate the obligation if the borrower failed to pay any amount when due. Additionally, the lender was authorized to take possession of the collateral without notice to the borrower if the borrower defaulted. When the borrower had difficulty making payments on time, the lender worked out a plan to assist the borrower in making the payments. But, when the borrower still could not make timely payments, the lender accelerated the obligation and took possession of the collateral.

The borrower sued, and the Alaska Supreme Court allowed recovery of both actual and punitive damages.[152] The fact that the lender was authorized to take the actions it took under the contract made no difference. The court did not even find that authorization to be unconscionable. Rather, the court simply said that the terms were superseded by the lender's attempts to accommodate the borrower in the past.[153] This holding is rendered particularly egregious by the fact that there were actually two loans involved, and the conciliations to the borrower were made on the first loan, while the acceleration and possession of collateral were made with regard to the second loan. Thus, the court was applying acts with regard to one loan to override the written provisions of a second loan. As one commentator noted, "[t]he *Fairco* decision illustrates a flagrant misuse of the good faith performance obligation."[154]

147. *See* Patricia A. Milon, Recent Development, *Implied Covenants of Good Faith and Fair Dealing: Loose Cannons of Liability for Financial Institutions?*, 40 VAND. L. REV. 1197 (1987).

148. 674 P.2d 288 (Alaska 1983).

149. 209 Cal. Rptr. 551 (Cal. Ct. App. 1985).

150. 689 P.2d 1226 (Mont. 1984).

151. 674 P.2d 288 (Alaska 1983).

152. *Id.* at 293.

153. *Id.*

154. Jill Pride Anderson, Note, *Lender Liability For Breach of the Obligation of Good Faith Performance*, 36 EMORY L.J. 917, 936 (1986).

In *First National Bank v. Twombly*,[155] the Supreme Court of Montana held that "[w]hen the duty to exercise good faith is imposed by law rather than by the contract itself, ... the breach of that duty is tortious," and therefore supports an award of punitive damages.[156] There, the lender had accelerated a loan and taken an offset against the borrower's deposit account after the borrower defaulted. The *Twombly* decision was based in part on the holding of *Commercial Cotton Co. v. United California Bank*,[157] where a bank was found to have negligently debited a depositor's account for a check indorsed with unauthorized signatures. There, the court found punitive damages justified because of the "special relationship" between the depositor and the bank[158] and because the bank affected the "public welfare."[159]

Despite the holdings of *Alaska Statebank*, *Twombly*, and *Commercial Cotton*, other courts have refused to ignore the written words of an agreement. For example, in *Cobb v. Midwest Recovery Bureau Co.*,[160] the Minnesota Supreme Court refused to allow recovery of punitive damages when a lender improperly repossessed collateral. The loan agreement in that case authorized the repossession, and the lender, in good faith, was not aware that the acceptance of late payments or the making of other conciliations to the borrower would estop it from pursuing contractually authorized remedies. Similarly, in *Van Bibber v. Norris*,[161] the Indiana Supreme Court found no breach of the obligation of good faith and fair dealing as long as the security agreement authorized the conduct in issue.

Allowing punitive damages in cases based essentially on a contractual relationship makes little sense if the parties possess equal bargaining strength.[162] The parties in such a relationship have the ability to set their own standards of conduct and to provide for limitation, expansion, or liquidation of their remedies upon the occurrence of a breach. Therefore, there is no need to satisfy the injured party's feelings and allay community resentment by imposing punitive damages.[163]

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155. 689 P.2d 1226 (Mont. 1984).

156. *Id.* at 1230.

157. 209 Cal. Rptr. 551 (1975).

158. For a full discussion of when a lender may be liable to its borrower as a result of their "special relationship," see Kenneth M. Lodge & Thomas J. Cunningham, *The Banker As Inadvertant Fiduciary: Beware the Borrower's Special Trust & Confidence*, COM. L.J. (forthcoming 1993).

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

160. 295 N.W.2d 232 (Minn. 1980).

161. 419 N.E.2d 115 (1980).

162. Note that *Twombly*, at least, tried to avoid characterizing the action as "contractual." *Twombly* said that the duty to exercise good faith was a tort duty, not a contractual duty. First Nat'l Bank v. Twombly, 689 P.2d 1226, 1230 (Mont. 1984).

163. 5 CORBIN, *supra* note 135, § 1077 at 438.

Some commentators have argued that the law should require parties to keep their promises by imposing greater liabilities upon breaching parties.[164] These commentators believe that the notions of "laissez-faire economics" which underlie traditional freedom of contract concepts are outdated theories that have little utility in the modern world.[165]

Those commentators and courts that believe a lender should be punished for pursuing contractually authorized courses of action through the use of punitive damage awards do a disservice to borrowers. In the end, lenders will refuse to accept late payments or make other conciliatory agreements to borrowers if courts continue to apply concepts such as waiver and estoppel to prevent their later exercise of contractual rights. Obviously, lenders are not having difficulty finding borrowers who will agree to the terms which allow actions such as those taken in *Alaska Statebank*, *Twombly*, and *Commercial Cotton*. It makes little sense, therefore, to punish the lender for behavior that benefits the borrower.

Additionally, the public has an interest in the financial soundness of the nation's lenders, as evidenced by the recent Savings and Loan crisis.[166] Allowing courts to hold lenders liable for actions taken consistent with their contractual agreements fails to recognize that parties may alter their duties implied in law. The public shares just as much of an interest in predictable functioning of lending relationships as it does in seeing that lenders are punished for acting improperly. Borrowers concerned about acceleration or repossession without notice should not allow those provisions to be a part of their relationships. Borrowers may also protect themselves with liquidated damages clauses and other contractual protective devices. If a borrower is unable to reach agreement with a lender on the permissible actions of the lender, the borrower may seek financing elsewhere.

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164. *See* GRANT GILMORE, THE DEATH OF A CONTRACT 94-103 (1974); Thomas P. Egan, *Legal Doctrines Operating Against The Express Provisions of A Written Contract (Or When Black and White Equal Gray)*, 5 DEPAUL BUS. L.J. 261 (1993); Eric M. Holmes, *Is There Life After Gilmore's Death of Contract? — Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330, 334 (1980).

165. *See* Egan, *supra* note 164, at 311-12; JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE 23-26 (1967); Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249, 277-84 (1975); Matthew O. Tobriner & Joseph R. Grodin, *The Individual and the Public Service Enterprise in the New Industrial State*, 55 CAL. L. REV. 1247, 1247-49, 1251-54 (1967).

166. Many experts believe that Bank failures in the 1990s will reach the same magnitude of the Savings and Loan failures of the 1980s. ATLANTA CONST., Jan. 5, 1987, at 1, col. 1.

C. Prejudgment Interest

In many jurisdictions, a plaintiff will not be able to recover prejudgment interest in the absence of such a provision in the loan documentation or statutory authority.[167] On the other hand, such interest may be recovered in cases based upon breach of contract if damages are liquidated.[168]

Courts allow the recovery of prejudgment interest when damages are liquidated by reasoning that if the defendant knows what the damages are, the defendant can stop the accrual of the interest by paying the claim. When the damages are not certain, however, the lender is unable to determine its liability prior to trial and should not be penalized for not paying damages prior to the judgment.[169] The more appropriate view, however, is that money has a use value and that prejudgment interest compensates the borrower for the lender's wrongful denial of the use of the money it had contracted to borrow. Although the lender did not technically owe the money until the judgment was entered, the basis for the obligation occurred much earlier than the judgment. The judgment is merely a legal recognition of the obligation, providing the borrower with a means of enforcing an obligation which already existed.[170] Under this view, the interest should be recoverable whether damages are liquidated or not.

Despite the fact that prejudgment interest will be allowed when statutorily or contractually provided for, lenders would be wise to define the point in time at which the damages accrue. Obviously, a lender would want this accrual to occur as late as possible. Additionally, the lender may want to point out that allowing prejudgment interest encourages plaintiffs to delay the progress of a lawsuit and provides disincentives for lenders to raise meritorious defenses. These arguments have not been successful in other cases, however.[171]

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167. *See, e.g.*, Monetti v. Anchor Hocking Corp., No. 87 C 9594, 1992 U.S. Dist. LEXIS 5508, *8 (N.D. Ill. Mar. 20, 1992).

168. *See* Farwell Const. Co. v. Ticktin, 405 N.E.2d 1051 (Ill. App. Ct. 1980).

169. *See* Trans-Global Alloy Ltd. v. First Nat'l Bank, 583 So.2d 443, 457 (La. 1991); Anthony E. Rothschild, Comment, *Prejudgment Interest: Survey and Suggestion*, 77 NW. U.L. REV. 192 (1982).

170. *See* State v. Phillips, 470 P.2d 266 (Ala. 1970); Argonaut Ins. Co. v. May Plumbing Co., 474 So.2d 212 (Fla. 1985); Emery v. Tilo Roofing Co., 195 A. 409 (N.H. 1937); Laudenberger v. Port Auth., 436 A.2d 147 (Pa. 1981); Cavnar v. Quality Control Parking, Inc., 696 S.W.2d 549 (Tex. 1985); Kent W. Seifried, Comment, *Recovery of Prejudgment Interest On An Unliquidated State Claim Arising Within the Sixth Circuit*, 46 U. CINN. L. REV. 151 (1977).

171. *See Trans Global Alloy*, 583 So.2d at 458.

IV. Reducing Damages Contractually

One method by which a lender can reduce potential damages in a lender liability case is through the use of contractual clauses. The most common of these are contractual waivers of consequential damages and waivers of the right to a jury. In addition to these, lenders would be wise to include clauses allowing a choice of law or forum, an anti-adhesion clause, and a forbearance agreement.

A. *Choice of Law or Choice of Forum*[172]

The ability to choose where one's action will be heard and what law will be applied is significant. One can easily see how having Virginia's hard and fast "new business rule" apply to a lender liability case would be helpful to a lender.[173] Choosing the applicable law and location of any action can be extremely beneficial and should not be overlooked in drafting loan documentation.

A lender may include a choice of forum clause in loan documentation as long as there is no fraud on the part of the lender.[174] Such a clause must be clear and explicit,[175] and the chosen forum must bear some reasonable relationship to either the parties or the transaction.[176]

Choice of law provisions are similar to choice of forum clauses, and will usually be respected so long as the law chosen to apply bears some reasonable relationship to either the parties or the transaction.[177]

B. *Jury Waiver*[178]

Conventional wisdom holds that a lender should seek to avoid juries.[179] This "wisdom" is based on the many large awards made to borrowers and against lenders by juries.[180] The alternative, however, may be no better. In *Penthouse International v. Dominion Federal Savings &*

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172. *See* Appendix A for an example of a choice of law or forum clause.

173. *See supra* notes 119-24 and accompanying text.

174. *Cf.* Mercury Coal & Coke, Inc. v. Mannesmann Pipe and Steel Corp., 696 F.2d 315 (4th Cir. 1982).

175. Credit Alliance Corp. v. Crook, 567 F. Supp. 1462 (S.D.N.Y. 1983).

176. Hall v. Superior Court, 150 Cal. App. 3d 411 (1984). New York allows cases involving at least $250,000 to specify New York as the forum regardless of whether the contract bears a reasonable relationship to the state. N.Y. GEN. OBLIG. LAW § 5-1402 (McKinney 1987).

177. *See* Smith, Valentino & Smith, Inc. v. Superior Court, 17 Cal. 3d 491, 494 (1976); Frame v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 20 Cal. App. 3d 668, 673 (1971).

178. *See* Appendix B for an example of a jury waiver clause.

179. Alvin B. Davis, *The Case Against Juries in Lender Liability*, ABA BANKING J. 184 (October 1987).

180. *See* examples cited *supra* note 13.

Loan Ass'n,[181] a $129 million lender liability award was made, not by a jury, but by a judge. Jury waiver clauses should therefore not be considered a panacea. Nevertheless, if a particular lender would feel more comfortable in front of a judge than a jury, there can be little harm in including a contractual jury waiver.

There are essentially three requirements for a valid jury waiver. First, it must be contained in a valid contract. If the contract is not valid — that is if it was induced fraudulently or by duress — then the jury waiver clause will not be effective.[182] Second, the waiver must be supported by consideration.[183] This consideration could take the form of a mutual waiver by both the lender and the borrower.[184] Third, the waiver must be clear and conspicuous.[185] To meet this requirement, lenders are advised to place the waiver just above the signature lines.[186] No matter how clear the waiver is, if it is buried in fine print, it will be unenforceable against the borrower.[187]

In addition to these three technical requirements, a jury waiver must be knowing, voluntary, and intelligent.[188] Although the three technical requirements assist in satisfying the broader policy of ensuring knowing, voluntary, and intelligent waivers, a lender should be sure to explain the jury waiver to the borrower and should document that explanation so that it can prove the explanation was made. It may be helpful to have the borrower's counsel acknowledge the waiver.[189]

C. Arbitration

Some commentators have suggested that lenders may reduce their exposure to runaway jury verdicts by including arbitration clauses in their loan agreements.[190] These commentators point out several advantages of

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181. 665 F. Supp. 301 (S.D.N.Y. 1987).

182. *See* Bank of New York v. Cheng Yu Corp., 413 N.Y.S.2d 471 (2nd Dep't 1979).

183. Robert H. MacKinnon & Nathan M. Eisler, *Drafting Lending Documents To Avoid Lender Liability Claims*, *in* LENDER LIABILITY LITIGATION, 1988, at 746 (PLI 1988).

184. *Id.*

185. *See* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 756 (6th Cir. 1985).

186. *See, e.g.*, N. Feldman & Son, Ltd. v. Checker Motors Corp., 572 F. Supp. 310, 312 (S.D.N.Y. 1983); Smith-Johnson Motor Corp. v. Hoffman Motors Corp., 411 F. Supp. 670 (E.D. Va. 1975).

187. National Equip. Rental, Ltd. v. Hendrix, 565 F.2d 255, 258 (2d Cir. 1977).

188. MacKinnon & Eisler, *supra* note 183.

189. *See* Ricker v. United States, 417 F. Supp. 133, 139-40 (D. Me. 1976).

190. *See, e.g.*, *California Banks Using Arbitration To Cut Court Costs, Avoid Jury Verdicts*, BNA'S BANKING REP., Mar. 28, 1988, at 544; *California Banks Turning To Arbitration Clauses; Huge Awards for Damages Prompt Lenders to Seek Protection from Lawsuits*, AM. BANKER, Sept. 11, 1987, at 2; William W. Park, *When the Borrower and the Banker Are at Odds: The Interaction of Judge and Arbitrator in Trans-Border Finance*, 65 TULANE L. REV. 1323, 1327 (1991).

requiring arbitration. First, arbitration is generally faster than litigation.[191] The American Arbitration Association has reported that approximately 90% of all arbitration claims are resolved within six months to a year, with most taking no more than a day or two to resolve.[192] Second, arbitration is cheaper than litigation. "A Presidential Commission found that arbitrations typically require only 50% to 85% of the cost of comparable court litigation."[193] This savings is accomplished through reduced discovery and its attendant disputes.[194]

However, one of the factors that would allow a lender to save money by presenting a case to arbitrators provides the basis for our recommendation that lenders *not* include an arbitration clause in their loan documentation. Arbitration prevents lengthy and expensive appeals. The decisions of arbitrators are usually reviewable only for fraud, partiality, corruption, or gross misconduct by the arbitrator.[195] Unfortunately, it is usually only the lender who is inclined to appeal adverse rulings.

It should be noted that arbitration is primarily designed to lift the burdens of an overloaded docket from the courts, and that therefore, courts are not willing to allow all arbitration matters to be placed back in their laps.[196] This concept was recognized by the United States Supreme Court as early as 1854, when it held, "If the award is within the submission, and contains the honest decision of the arbitrators, after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or in fact."[197] "It is the essence of the law of arbitration that the scope of judicial review of arbitration awards is very limited . . . For practical purposes, therefore, unless a statutory ground for vacating or modifying the award is established, the award will be confirmed."[198] Even when an arbitration panel makes gross errors of judgment regarding the law or

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191. Michael L. Weisman, *Drafting to Avoid Lender Liability*, *in* Documenting The Commercial Loan: Doing it Right (1990).

192. *Id.*

193. *Id.*

194. This is not always the case. For example, in a dispute between Condec Corporation and Kaiser Aluminum, the arbitration took over eight years and involved "more than 30,000 pages of transcripts, 5,000 exhibits, 2,500 pages of briefs, 200 hearing days, and a final opinion of more than 600 pages." Lyons, *Arbitration, The Slower, More Expensive Alternative*, AM. LAW., Jan. - Feb. 1985, at 107. There is obviously no way to know what the difference would have been had the dispute been before a court, but this example should at least dispel the notion that arbitration is quick, simple, and inexpensive in every case.

195. Uniform Arbitration Act, 7 U.L.A. (1985 & Supp. 1992). The Uniform Arbitration Act has been adopted in 35 states and the District of Columbia.

196. *See, e.g.*, Warren E. Burger, *Using Arbitration to Achieve Justice*, 40 ARB. J., Dec. 1985, at 3.

197. Burchell v. Marsh, 58 U.S. 344, 349 (1854).

198. GEORGE GOLDBERG, A LAWYER'S GUIDE TO COMMERCIAL ARBITRATION 65-67 (1977).

mistakes of fact, or is flat out wrong in its application of the law, a court will refuse to vacate the award unless the statutory basis is met.[199] One commentator stated: "Unlike judges, arbitrators are not required, strictly speaking, to apply rules of law. Rather, arbitrators are expected to be just, fair, and equitable, basing their decision on common sense."[200]

Arbitration panel decisions are unlikely to be in writing, and there will usually not be a court reporter present during the proceedings.[201] Thus, there would be very little record upon which to base an appeal in any event. Essentially, arbitration provides a way for courts to lighten their dockets and for the parties to save a little money, but at the expense of the opportunity to have the decision reviewed.[202] For this reason, lenders should be advised not to include arbitration clauses in their loan documentation.[203]

Some lenders may be concerned about runaway jury verdicts, and hope that arbitrators will be less likely to make huge awards in the event liability is established. There is no evidence, however, that arbitrators are more conservative than juries in making their awards.[204] In fact, there is evidence that judges are just as likely as juries to make large awards, a fact which should cause some concern as to whether an arbitration panel would be any more restrained.[205]

199. *See, e.g.*, Raugh v. Rockford Prod. Corp., 574 N.E.2d 636 (Ill. 1991).

200. Special Project Note, *Lender Liability and Arbitrator: Preserving the Fabric of Relationship*, 42 VAND. L. REV. 947, 964 (1989) (citing James Acret, *Arbitrate or Litigate?*, 5 CAL. LAW., June 1985, at 67; Hugh R. Jones, *Arbitration From the Viewpoint of the Practicing Attorney: An Analysis of Arbitration Cases Decided By The New York State Court of Appeals From January, 1973 to September, 1985*, 14 FORDHAM URB. L.J. 523, 525 (1986); S. REP. NO. 536, 68th Cong., 1st Sess. 3 (1924)) [hereinafter Special Project Note, *Arbitration*].

201. Steven A. Meyerowitz, *The Arbitration Alternative*, 71 A.B.A.J. Feb. 1985, at 78.

202. Or, for that matter, to try their dispute fully informed.

203. Bank of America is the most noted user of arbitration clauses in commercial loan agreements. So far that Bank has indicated that it is pleased with the results, but cautions that it has little experience. It believes that the presence of the arbitration clause assists it in negotiation and settlement. Special Project Note, *Arbitration*, *supra* note 200, at 976 n.196.

Others have suggested that arbitration may be used in a macro sense to prevent the "domino effect" of large lender liability verdicts. These commentators believe that one reason juries return such high verdicts is because earlier large verdicts are so well publicized. By resorting to arbitration, the verdicts are kept private and, therefore, do not encourage more litigation. Special Project Note, *Arbitration*, *supra* note 200, at 977 n.207 (citing Walsh, *Common Law Claims Against Lenders*, *in* LENDER LIABILITY LITIGATION 1988, at 9, 12 (PLI 1988)).

204. The lack of any empirical studies comparing litigation to arbitration has been noted. *See* Kritzer & Anderson, *The Arbitration Alternative: A Comparative Analysis of Case Processing Time, Disposition Mode, and Cost in the American Arbitration Association and the Courts*, 8 JUST. SYS. J. 6, 7 (1983).

205. There is some question as to whether an arbitration panel may award punitive damages. Traditionally, at least, that power has been held to be available only to courts. Hoellering, *Remedies in Arbitration*, 20 FORUM 516, 520 (1985). The leading case upholding this proposition is *Garrity*

One possible reconciliation for lenders under pressure to reduce legal fees might be to include an arbitration clause in consumer loan documentation, but not in commercial loan documentation. By doing so, the lender hedges, saving some money in defending lender liability actions by consumers, where significantly less money is likely to be at stake. In commercial cases, where astronomical sums may be involved, the lender will be secure in the knowledge that it will be able to obtain full discovery and review of any adverse decisions.

D. *Waiver of Consequential Damages*[206]

In some cases, the consequential damage waiver may reduce the damages available to a borrower. Consequential damage waiver clauses have been upheld as valid by many courts.[207] They will only be operable, however, when the plaintiff is proceeding upon a tort theory.[208] The case of *Orkin Exterminating Co. v. Walters*[209] involved a lawsuit sounding in both contract and tort. The tort alleged was "negligent breach of contract." In that situation, the Indiana Court of Appeals held that the plaintiff could not sue in tort simply to avoid the limitation of damages clause. However, this implies that a proper suit in tort would not be impacted by a contractual clause limiting damages. Rather, the plaintiff was prompted to file a tort action by its intention to evade the limitation clause, even though the facts were simply indicative of a breach of contract.

A case similar to the *Orkin* case is *Motif Construction Corp. v. Buffalo Sav. Bank.*[210] There, the plaintiff was a developer who alleged that the

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v. Lyle Stuart, Inc., 353 N.E.2d 793 (N.Y. 1976). Some courts, such as *Shaw v. Kuhne & Ass'n*, 698 P.2d 880 (N.M. 1985) and *School City of East Chicago v. East Chicago Federation of Teachers*, 422 N.E.2d 656 (Ind. Ct. App. 1981) have followed the reasoning of *Garrity* that punitive damages are a form of punishment, which may only be imposed by the state. Other courts have disagreed, however. *See, e.g.*, Willis v. Shearson/American Express, Inc., 569 F. Supp. 821 (M.D.N.C. 1983); Willoughby Roofing & Supply Co. v. Kajima Int'l, Inc., 598 F. Supp. 353 (N.D. Ala. 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985); Baker v. Sadick, 208 Cal. Rptr. 676 (1984); Rodgers Builders, Inc. v. McQueen, 331 S.E.2d 726 (N.C. Ct. App. 1985); Grissom v. Greener & Sumner Constr., Inc., 676 S.W.2d 709 (Tex. Ct. App. 1984).

206. *See supra* note 87 for an example of a waiver of consequential damages clause.

207. *See, e.g.*, Frey Dairy v. A.O. Smith Harvestore Prod., Inc., 886 F.2d 128, 132 (6th Cir. 1989); A.M.R. Enter., Inc. v. United Postal Sav. Ass'n, 567 F.2d 1277, 1282 (5th Cir. 1978); WXON-TV, Inc. v. A.C. Nielsen Co., 740 F. Supp. 1261, 1264-65 (E.D. Mich. 1990).

208. *See* Barribeau v. Hansen Auto Sales, 384 N.W.2d 366 (Wis. Ct. App. 1986) ("The court properly allowed consequential damages. While the contract disallowed consequential damages, this is not an action on the contract."). *See also* Conway Pub., Inc. v. Data Gen. Corp., No. C82-1862A (N.D. Ga. Slip Op. August 17, 1983) (contractual limitation of consequential damages does not preclude their recovery under tort theories).

209. 466 N.E.2d 55 (Ind. Ct. App. 1984).

210. 374 N.Y.S.2d 868 (1975).

defendant bank agreed to grant construction loans to the developer but then failed to lend the money when the developer began work on the project. As a result, the plaintiff claimed a loss of profits and serious damage to its reputation, causing it to become insolvent. The defendant conceded to the causes of action based upon breach of contract, and the question on appeal was whether or not the counts based upon "prima facie tort" were viable. The New York Court of Appeals wrote: "[u]nless the contract creates a relation out of which relation springs a duty, independent of the mere contract obligation (here, to lend money to plaintiff on building loans) though there may be a breach of contract, there is no tort, since there is no duty to be violated."[211] The court found the plaintiff had alleged no duty on the part of the defendant independent of the contract relation. It further noted that the plaintiff's affidavits in opposition to the motion for summary judgment failed to set forth facts that would show the defendant acted tortiously. It is unclear whether the *Motif* court would have allowed consequential damages had the tort claims survived.

A bank that has a contractual waiver of consequential damages in its lending agreements may argue that the waiver applies to all conduct arising out of the contractual relationship. A tort, however, usually arises independent of a contract, although it may relate to obligations growing out of a contract.[212] If a borrower is successful in arguing that the tortious conduct stands apart from the contract, consequential damages will not be barred by the waiver.

E. Anti-Adhesion Clause

The anti-adhesion clause is a device that can be used by lenders to forestall arguments by borrowers that certain provisions in the loan documentation are unconscionable. The Restatement (Second) of Contracts states:

> If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result.[213]

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211. *Motif*, 374 N.Y.S.2d at 870 (quoting Rich v. N.Y.C. & H.R.R.R. Co., 87 N.Y. 382, 395 (1882)).

212. Stella Flour & Feed Corp. v. National City Bank, 136 N.Y.S.2d 139 (1954), *aff'd*, 127 N.E.2d 864 (N.Y. 1955).

213. RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981).

The mere fact that the lender in most instances will be in a superior bargaining position to the borrower will not provide the borrower with a basis to argue unconscionability. If the borrower can show a *gross* inequality of bargaining power, however, coupled with terms unreasonably favorable to the lender, or if the borrower can show that it had no meaningful choice or alternative to the unfair terms, it will be able to claim that the term (or the entire agreement) is unconscionable.

This argument might be prevented by including a clause such as the following in the loan documentation: "This Agreement shall not be construed to have originated with either party and the parties herein have been fully represented by counsel in the drafting and negotiation of this Agreement."[214] As there is no significant case law on the subject, the legal effect of such a clause has yet to be determined.

F. Liquidated Damages

Borrowers who are starting new businesses would be wise to include a liquidated damages clause, as this will help them avoid difficulties in jurisdictions following the new business rule.[215] For example, in *Guard v. P & R Enterprises, Inc.*,[216] the Alaska Supreme Court noted that the absence of such a provision harmed the plaintiff's claim. Recall also that inclusion of a liquidated damages provision allows the plaintiff to recover prejudgment interest.[217] Nevertheless, the advantages to the lender of having a liquidated damages clause outweigh the disadvantages. Although in some situations a lender may reduce its potential liability by not having a liquidated damages clause, as when the jurisdiction applies the new business rule and thus denies the borrower a recovery without such a clause, in far more cases, the uncertainty that goes along with the absence of a liquidated clause is not worth the risk. It is far better for the lender to know where it stands should difficulties develop. Therefore, lenders should specify in their loan documentation what damages will be recoverable by the borrower in the event the lender breaches.

G. Forbearance Agreement

A forbearance agreement is a workout device employed by lenders to maintain the lending relationship after a borrower begins to show signs of weakening, while strengthening the lender's own position. The forbearance agreement gives the troubled borrower additional time to get itself together

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214. Weisman, *supra* note 191, at 441.
215. *See supra* notes 103-24 and accompanying text for a discussion of the new business rule.
216. 631 P.2d 1068 (Alaska 1981).
217. Farwell Const. Co. v. Ticktin, 405 N.E.2d 1051 (Ill. App. Ct. 1980).

or seek alternative financing. The borrower, in turn, admits that it is in default, that the cure period has expired, and that the specific dollar amount is due and owing. In addition, the lender may be able to get the borrower to confirm the validity of all security interests, to agree that the borrower has no defenses to the lender's exercise of its remedies with regard to those interests, and to waive any defenses, counterclaims, setoff, or other claim the borrower (or guarantor) may hold.

A forbearance agreement is an excellent method for a lender to strengthen itself against a lender liability suit should one be suspected. In addition, the forbearance agreement allows the lender to maintain a lending relationship with a borrower who has a genuine possibility of rehabilitation.

H. Advance Notice of Termination

A lender should always give its borrower the opportunity to seek alternative financing before terminating a line of credit. This was the mistake of Irving Trust in the *K.M.C.* case. Failure to give advance notice of termination will enhance the likelihood of a finding of bad faith by a court. Lenders are therefore strongly urged to provide defaulted borrowers with written advance notice of termination.

V. Borrower Liability: Turning The Tables

Lenders are not the only parties potentially guilty of wrongdoing in a lending relationship, although they seem to be the only party ever to be punished.[218] Borrowers are often guilty of some misconduct in a lending relationship.[219] Where a borrower has behaved inappropriately, the lender should have either an independent cause of action or a defense to the borrower's lender liability action.[220]

In 1991, a jury awarded NCNB Texas National Bank $735,000 in damages from its borrower, 5-M Commercial Services Co.[221] In that case, the lender sued the borrower, alleging that the borrower either

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218. *See* James R. Butler, *Is Lender Liability Now Absolute Liability?*, 15 W. ST. U. L. REV. 595, 605 (1988).

219. Perhaps the greatest example of borrower misconduct occurs in consumer mortgages. A recent study indicated that as many as 11.3% of all mortgage applications include "material misrepresentations" by an individual borrower, mortgage broker, appraiser, or others. Kenneth R. Harney, *Lenders Are Out To Get Those Who Lie On Mortgage Applications*, STAR TRIB., June 20, 1992, at 3R; Kenneth R. Harney, *Mortgage Lenders Disturbed by Increased Borrower Fraud*, ATLANTA CONST., June 21, 1992, at Sec. H, p. 16.

220. Remember that often the best defense is a good offense.

221. Paula Moore, *NCNB's Legal Victory Could Turn Legal Tides Against Borrowers*, SAN ANTONIO BUS. J., July 19, 1991, at 2.

intentionally or unintentionally misrepresented its solvency in applying for a $150,000 loan.[222] The borrower returned fire, accusing the bank of breaching an oral agreement and of using the bank's large size to take advantage of a small business.[223] Despite the borrower's lamentations, the jury sided with NCNB.

Some attorneys speculate that the NCNB verdict signals a trend toward borrower, rather than lender, liability. In light of the savings and loan debacle and the impending bank crisis, jurors have become aware that banks do not print money, that there is only a finite supply of it, and that large recoveries by borrowers ultimately come from the pockets of ordinary people. Thus, when a borrower acts improperly, jurors are willing to compensate the lender for its losses.

Not all borrower liability actions will be successful, however. For example, in 1991 the Court of Appeals for the Second Circuit held that Chrysler Capital Realty, a lender, could not recover a loss incurred as a result of fraud in the inducement.[224] The lender had extended a $12 million loan to a limited partnership so that the partnership could purchase a building. The loan was secured by a mortgage on the building. When the borrower defaulted, the lender bid for the building at its auction in the amount owed on the loan. The lender then sued the borrower for $5.3 million, alleging that the property was only worth $7.4 million at the time of the sale. The lawsuit alleged fraud, negligent misrepresentation, breach of contract, and other tort claims.

The Second Circuit, relying on *Whitestone Savings & Loan Ass'n v. Allstate Insurance Co.*,[225] upheld the district court's dismissal of the lender's complaint on the basis that the lender received full satisfaction of the debt by acquiring the property through foreclosure.[226] The court rejected the lender's arguments that borrowers should not be shielded from liability for their fraudulent conduct. The court replied that the policy of finality in foreclosure sales outweighs concerns of fraudulent actions by borrowers.

Regardless of whether there has been a shift from lender liability to borrower liability, all agree that the boom of lender liability cases in the 80s

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222. The bank alleged that the borrower submitted financial statements listing assets it did not own, failed to list debts, and inflated the value of company equipment.

223. The borrower also alleged the bank comitted usury by loaning money to an individual guarantor and then requiring the money to be paid back by the corporation. The judge dismissed this claim.

224. Chrysler Capital Realty, Inc. v. Grella, No. 90-7549 (2d Cir. Aug. 19, 1991).

225. 270 N.E.2d 694 (N.Y. Ct. App. 1971).

226. *See also* Sumitomo Bank v. Taurus Developers, Inc., 229 Cal Rptr. 719 (Cal. Ct. App. 1986) (holding that a lender making a full amount bid was prevented from suing for deficiency).

has not carried over into the 90s.[227] This may be the result of lower loan volume, or of greater consideration for the interests of lenders by courts and juries. Most likely, it is some combination of the two.

In addition, many states have begun to enact legislation intended to shield lenders from spurious claims by borrowers of oral promises and modifications to loan agreements. These "credit agreement statutes" require all modifications to loan agreements to be in writing.[228] It is too early to tell what impact this legislation will have on the lending industry, but it is expected to be beneficial to lenders.

VI. Conclusion

The lesson to be learned from cases such as *K.M.C.* and *Alaska Statebank* is that lenders should be hesitant to extend favors to borrowers. A lender wishing to maintain a good relationship with a borrower should negotiate a forbearance agreement that clearly states the lender's retention of its contractual rights. Before foreclosing or taking other action, lenders must give borrowers a reasonable period of notice. No verbal assurances should be given that run counter to the terms of the written agreement.[229]

Lenders defending against lender liability lawsuits should consider carefully the theories being relied upon by the borrower. As often as

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227. *See* Moore, *supra* note 221, at 2.

228. *See* ALA. CODE § 8-9-2(7) (Supp. 1993); ALASKA STAT. § 09.25.010(a)(13) (Supp. 1993); ARIZ. REV. STAT. ANN. § 44-101(9) (Supp. 1993); ARK. CODE ANN. § 4-59-101(d)-(e) (Michie Supp. 1993); CAL. CIV. CODE § 1624(g) (West Supp. 1993); COLO. REV. STAT. § 38-10-124 (Supp. 1993); CONN. GEN. STAT. ANN. § 52-550(a)(6) (West Supp. 1993); DEL. CODE ANN., tit. 6, § 2714(b) (Supp. 1993); FLA. STAT. ANN. § 687.0304 (West 1993); GA. CODE ANN. § 13-5-30(7) (Michie Supp. 1993); HAW. REV. STAT. § 656-1(8) (Supp. 1993); ILL. ANN. STAT. ch. 17, paras. 7101-03 (Smith-Hurd Supp. 1992); IND. CODE ANN. § 32-2-1.5 (Burns 1993); IOWA CODE ANN. § 535.17 (West Supp. 1993); KAN. STAT. ANN. §§ 16-117 to -119 (1988); KY. REV. STAT. ANN. § 371.010(9) (Michie/Bobbs-Merrill Supp. 1993); LA. REV. STAT. ANN. §§ 6:1121-23 (West Supp. 1993); MD. CTS. & JUD. PROC. CODE ANN. § 5-317 (1991); MINN. STAT. § 513.33 (1990); MO. ANN. STAT. § 432.045 (Vernon Supp. 1993); NEB. REV. STAT. ANN. §§ 45-1,112 to -1,115 (Supp. 1993); NEV. REV. STAT. ANN. § 11.220(4)-(5) (Michie Supp. 1993); N.J. STAT. ANN. § 25:1-5 (1993); N.M. STAT. ANN. § 58-6-5 (Michie 1993); N.C. GEN. STAT. § 22-5 (Supp. 1993); N.D. CENT. CODE § 9-06-04(4)-(5) (Supp. 1993); OKLA. STAT. ANN. tit. 15, § 140 (West Supp. 1993); OR. REV. STAT. ANN. § 41.580(1)(h) (Butterworth Supp. 1993); S.D. CODIFIED LAWS ANN. § 53-8-2-(4) (1993); TENN. CODE ANN. § 29-2-101(b) (Supp. 1993); TEX. BUS. & COM. CODE ANN. § 26.02 (West Supp. 1993); UTAH CODE ANN. § 25-5-4(6) (Supp. 1993); VA. CODE ANN. § 11-2.9 (Michie Supp. 1993); WASH. REV. CODE ANN. § 19.36.110 to .140 (West Supp. 1993). *See also* Rural American Bank v. Herickhoff, No. CX-90-2341, 1992 Minn. LEXIS 154 (Minn. June 5, 1992); Drewes v. First Nat'l Bank, 461 N.W.2d 389 (Minn. Ct. App. 1990); Todd C. Pearson, Note, *Limiting Lender Liability: The Trend Toward Written Credit Agreement Statutes*, 76 MINN. L. REV. 295 (1991); Stephen A. Kouri and LeAnna L. Karnopp, *An Act in Relation to Credit Agreements: A Statutory Defense to Lender Liability*, ILLINOIS BAR JOURNAL 348 (July 1990).

229. Special Project Note, *Written Agreements in the Lender-Borrower Context: The Illusion of Certainty*, 42 VAND. L. REV. 917, 935 (1989).

possible, a lender will want to characterize a borrower's claims as contractual in nature and emphasize the expectations of the parties at the outset of the lending relationship. A lender should also consistently challenge the foreseeability of the borrower's alleged damages.

Where cases are based on theories essentially contractual in nature, the courts should consider the fact that the parties may modify some duties implied by law. While it is true that the duty to act in good faith cannot be modified per se, a lender and borrower may agree that the lender may take certain actions that might be considered in bad faith absent their agreement. Nevertheless, despite written agreements, a lender should attempt to give the borrower advance notice of termination whenever possible. The failure to do so may result in a finding of bad faith and higher damages based on a tort theory.

Finally, lenders who are sued by their borrowers would be wise to scrutinize the borrower's actions carefully. Where appropriate, a counterclaim can be very effective. Hopefully, with the public becoming more aware of the long-term effects of outrageous lender liability verdicts based upon emotion rather than logic, these excessive and unjustified awards will be reduced.

APPENDIX A

Here is an example of a typical choice of law or forum clause that will allow the lender to control where a borrower must sue the lender:

> Borrower hereby consents to the jurisdiction of any state or federal court located within Cook County, Illinois, and waives any objection it may have based on improper venue or *forum non conveniens* to the conduct of any proceeding instituted hereunder and consents to the granting of such legal or equitable relief as is deemed appropriate by the court.

APPENDIX B

Here is an example of a typical jury waiver clause lenders can include in their documentation if they wish to avoid having a jury hear a lawsuit brought by a borrower:

> Each party to this Agreement hereby expressly waives any right to trial by jury of any claim, demand, action or cause of action (1) arising under this Agreement or any other instrument, document or agreement executed or delivered in connection herewith, or (2) in any way connected with or related or incidental to the dealings of the parties hereto or any of them with respect to this Agreement or any other instrument, document or agreement executed or delivered in connection herewith, or the transactions related hereto or thereto, in each case whether now existing or hereafter arising and whether sounding in contract or tort or otherwise; and each party hereby agrees and consents that any such claim, demand, action, or cause of action shall be decided by court trial without a jury, and that any party to this agreement may file an original counterpart or a copy of this section with any court as written evidence of the consent of the parties hereto to the waiver of their right to trial by jury.