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## **An Agricultural Law Research Article**

# **Lender Liability and Discretionary Lending: Putting the Good Faith Performance Standard in Perspective**

by

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## LENDER LIABILITY AND DISCRETIONARY LENDING: PUTTING THE GOOD FAITH PERFORMANCE STANDARD IN PERSPECTIVE

Lenders and borrowers recently have focused their attention upon a developing area of law that courts have termed "lender liability".<sup>1</sup> In lender liability suits, borrowers that have entered into commercial credit transactions assert civil claims against commercial lenders.<sup>2</sup> In early lender liability suits, borrowers in actions against financial institutions relied on tort theories like fraud, duress, interference with contractual relations, and misrepresentation.<sup>3</sup> In more recent lender liability suits, borrowers have claimed that

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1. See generally AMERICAN BAR ASSOCIATION DIVISION OF PROFESSIONAL EDUCATION, EMERGING THEORIES OF LENDER LIABILITY (H. Chaitman ed. 1985) (examining impact that suits that borrowers have instituted against lenders alleging common law theories of such as fraud, duress, interference with contracts and undue influence have had upon commercial lending industry); AMERICAN BAR ASSOCIATION, LENDER LIABILITY LITIGATION: RECENT DEVELOPMENTS (R. Tufaro ed. 1987) (discussing theories used in recent suits that borrowers have instituted against lenders); Ebke & Griffin, *Lender Liability to Debtors: Toward a Conceptual Framework*, 40 Sw. L.J. 775 (1986) (discussing rapid increase in number of multimillion dollar suits that disgruntled borrowers have initiated against lenders); Granoff, *Emerging Theories of Lender Liability: Flawed Applications of Old Concepts*, 104 BANKING L.J. 492 (1987) (discussing precautions that lenders facing lender liability suits should take so that these lenders can prepare successful defenses against borrowers' claims of breach of good faith obligation, fraud, duress and breach of contract).

2. See, e.g., *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 766 (6th Cir. 1985) (affirming \$7.5 million jury verdict against commercial lender for breach of good faith obligation to borrower); *Sanchez-Corea v. Bank of Am.*, 38 Cal. 3d 892, 910, 215 Cal. Rptr. 679, —, 701 P.2d 826, 839 (Cal. 1985) (affirming \$1 million jury verdict against lender guilty of fraudulent misrepresentation); *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661, 667 (Tex. Civ. App. 1984) (affirming \$19 million jury verdict against lender guilty of fraudulent misrepresentation, duress, and tortious interference with contractual relations), *appeal dismissed by agreement*, Mar. 6, 1985.

Lender liability, as a multimillion dollar threat, first gained widespread attention in *State National Bank v. Farah Manufacturing Co.* See *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661, 667 (Tex. Civ. App. 1984), *appeal dismissed by agreement*, Mar. 6, 1985. In *Farah Farah Manufacturing Company*, an apparel firm, maintained an action against the State National Bank of El Paso. In Farah's suit, Farah alleged both fraud and duress when the bank demanded that the financially troubled company replace its directors. *Id.* The jury awarded Farah \$18,947,348.77 in damages. *Id.* at 666. Relying on the common law theories of fraud, duress, and tortious interference with contract, the Eighth Circuit Court of Appeals of Texas affirmed the jury verdict in *Farah*, stating that the lender improperly interfered with Farah's management by threatening to withhold needed financing from Farah unless Farah's current management resigned. *Id.* at 690.

3. See *Stirling v. Chemical Bank*, 382 F. Supp. 1146, 1153 (S.D.N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975) (holding that lender who induced resignations of borrower's directors and officers with fraudulent promise not to call borrower's loans was liable for resulting injuries to borrower); *State Nat'l Bank v. Farah Mfg. Co.*, 678 S.W.2d 661, 667 (Tex. Civ. App. 1984) (holding lender liable to borrower based upon theories of fraud, duress, and tortious interference with contract after lender threatened to declare borrower's loans in default and remove current management), *appeal dismissed by agreement*, Mar. 6, 1985.

lenders have breached the duty of good faith and fair dealing that the Uniform Commercial Code (U.C.C.) implies in every contract.<sup>4</sup> Many of the cases in which borrowers have asserted that lenders have breached an implied obligation to perform in good faith in commercial credit transactions have resulted from the lender's exercise of the lender's discretionary rights in collecting the balance due on the borrower's debt.<sup>5</sup> The discretionary rights of lenders that borrowers most often target in lender liability suits include the lender's right to accelerate a debt due at some specific future date,<sup>6</sup> the lender's right to demand full repayment of a debt not due at a

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4. See, e.g., *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 12 (1st Cir. 1987) (holding that lender in calling borrower's demand note breached good faith obligation that § 1-208 and § 1-203 of the U.C.C. imposed upon lender); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 763 (6th Cir. 1985) (holding that lender's exercise of lender's right to refuse to advance funds against borrower's line of credit without prior notice to borrower constituted breach of lender's good faith obligation); *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (holding that lender did not breach obligation of good faith that U.C.C. imposes when lender exercised right to demand full repayment of demand note); *Alaska Statebank v. Fairco*, 674 P.2d 288, 292-93 (Alaska 1983) (holding that lender breached good faith obligation by failing to notify borrower before repossessing collateral); *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (Ct. App. 1980) (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *First Nat'l Bank v. Twombly*, 689 P.2d 1226, 1230 (Mont. 1984) (holding that lender breached good faith obligation when one loan officer offset loan against borrower's deposit account after another loan officer agreed to change payment schedule of borrower's loan from single payment to installment payment).

5. See *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 12 (1st Cir. 1987) (holding that lender in calling borrower's demand note breached good faith obligation that § 1-208 and § 1-203 of the Uniform Commercial Code imposed upon lender); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 763 (6th Cir. 1985) (holding that lender's exercise of lender's right to refuse to advance funds against borrower's line of credit without prior notice to borrower constituted breach of lender's good faith obligation under U.C.C.); *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (holding that lender did not breach obligation of good faith that U.C.C. imposes when lender exercised right to demand full repayment of demand note); *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (Ct. App. 1980) (holding that section 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Crockett v. First Fed. Sav. & Loan Assoc.*, 289 N.C. 620, 625, 224 S.E.2d 580, 584 (1976) (stating that lender's acceleration of loan balance to increase interest rate constituted bad faith under U.C.C.); *Mitchell v. Ford Motor Credit Co.*, 688 P.2d 42, 44-45 (Okla. 1984) (holding that lender failed to exercise good faith when repossessing borrower's farm equipment because lender could not provide evidence of lender's good faith belief that borrower could not repay debt).

6. See, e.g., *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367, 1375 (9th Cir. 1979) (stating that lender's exercise of contractual right to accelerate borrower's debt upon borrower's breach of contract term constituted breach of lender's obligation of good faith because lender did not have good faith belief that borrower would not repay debt in accordance with section 1-208); *Alaska Statebank v. Fairco*, 674 P.2d 288, 292-93 (Alaska 1983) (holding that lender breached good faith obligation by failing to notify borrower before accelerating debt and repossessing borrower's collateral); *Smith v. Union State Bank*, 452 N.E.2d 1059, 1064 (Ind. Ct. App. 1983) (holding that section 1-208's good faith obligation limits lender's right to accelerate debts to instances in which lender believes in good faith that lender's prospect of

specific future date,<sup>7</sup> and the lender's right to refuse to advance funds on a line of credit without prior notice to the borrower.<sup>8</sup> In borrowers' actions arising from lenders' exercise of discretionary contractual rights, borrowers have alleged that although the lenders' collection actions, did not violate the express provisions of the loan agreement that governed the lender-borrower relationship, the lenders' actions did violate the lenders' implied obligation under the U.C.C. to deal with the borrower in good faith.<sup>9</sup> In response to borrowers' actions against lenders who allegedly have violated an implied obligation of good faith, several courts have applied the U.C.C.'s good faith provisions to alter the express terms of lending agreements.<sup>10</sup>

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full repayment is impaired); *Crockett v. First Fed. Sav. & Loan Assoc.*, 289 N.C. 620, 625, 224 S.E.2d 580, 584 (1976) (stating that lender's exercise of lender's right to accelerate delinquent loan balance constituted breach of lender's good faith obligation under U.C.C.); *State Bank v. Woolsey*, 565 P.2d 413, 417-18 (Utah 1977) (holding that good faith obligation in § 1-208 of U.C.C. applied to lender's decision to accelerate borrower's debt).

7. *See, e.g., Reid v. Key Bank of S. Maine*, 821 F.2d 9, 12 (1st Cir. 1987) (holding that lender in calling borrower's demand note breached good faith obligation that § 1-208 and § 1-203 of U.C.C. imposed upon lender); *Flagship Nat'l Bank v. Gray Distrib. Sys. Inc.*, 485 So. 2d 1336, 1340 (Fla. Dist. Ct. App. 1986) (holding that good faith obligation in § 1-203 of U.C.C. does not apply to demand notes); *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (Ct. App. 1980) (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (holding that § 1-203's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wash. App. 530, 536, 518 P.2d 734, 738 (holding that § 1-203's good faith obligation does not apply to demand notes), *review denied*, 83 Wash. 2d 1013, *cert. denied*, 419 U.S. 967 (1974).

8. *See, e.g., K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 763 (6th Cir. 1985) (holding that lender's exercise of lender's right to refuse to advance funds against borrower's line of credit constituted breach of lender's good faith obligation under U.C.C.); *Midlantic Nat'l Bank v. Commonwealth General*, 386 So. 2d 31, 34 (Fla. App. 4th Dist. 1980) (stating that lender could terminate borrower's line of credit without notice to borrower unless loan agreement specifically stipulated that lender provide borrower prior notice); *Grandin Indus., Inc. v. Florida Nat'l Bank*, 267 So. 2d 26, 29-30 (Fla. App. 4th Dist. 1972) (stating that lender may refuse to advance funds against borrower's line of credit at will, without prior notice to borrower).

9. *See K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 763 (6th Cir. 1985) (alleging that lender's exercise of lender's contractual right to refuse to advance funds against borrower's line of credit without prior notice to borrower constituted breach of lender's good faith obligation); *Alaska Statebank v. Fairco*, 674 P.2d 288, 292-93 (Alaska 1983) (alleging that lender breached good faith obligation by failing to notify borrower before repossessing collateral); *First Nat'l Bank v. Twombly*, 689 P.2d 1226, 1230 (Mont. 1984) (alleging that lender breached obligation of good faith by exercising lender's contractual right to offset loan balance against borrower's funds on deposit with lender).

10. *See, e.g., K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 763 (6th Cir. 1985) (holding that lender's exercise of lender's contractual right to refuse to advance funds against borrower's line of credit without prior notice to borrower constituted breach of lender's good faith obligation); *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367, 1375 (9th Cir. 1979) (stating that lender's exercise of contractual right to accelerate borrower's debt upon borrower's breach of contract constituted breach of lender's obligation of good faith under § 1-208 because lender

Because the lender-borrower relationship largely is contractual in nature, the good faith provisions of the U.C.C. govern the terms of the agreement between a lender and a borrower.<sup>11</sup> To balance the perceived need for minimum standards of good faith behavior in commercial contracts with the U.C.C.'s goal of promoting the expansion of commerce, the drafters of the U.C.C. adopted a flexible standard of good faith.<sup>12</sup> The drafters of the U.C.C. adopted a flexible standard of good faith so that contracting parties could adapt the good faith obligation to meet the particular requirements of the parties' situation.<sup>13</sup> Section 1-201(19) of the U.C.C. defines the U.C.C.'s minimum standard of good faith as "honesty in fact in the conduct or transaction concerned."<sup>14</sup> Section 1-203 of the U.C.C. extends section 1-201(19)'s good faith standard to the parties to every contract that the U.C.C. governs.<sup>15</sup> In addition to the general standard of good faith that section 1-203 sets forth, other sections of the U.C.C. establish specific

did not have good faith belief that borrower would not repay debt); *Alaska Statebank v. Fairco*, 674 P.2d 288, 292-93 (Alaska 1983) (holding that lender breached good faith obligation by failing to notify borrower before repossessing borrower's collateral despite express provisions in lending contract which borrower waived right to prior notice).

11. See U.C.C. Preamble (1987) (stating purpose and coverage of U.C.C.); see also U.C.C. § 1-203 (1987) (imposing obligation of good faith performance upon all parties to every contract that U.C.C. governs).

12. See U.C.C. § 1-102(2)(b) (1987) (stating that drafters of U.C.C. intended for U.C.C. to be construed liberally to facilitate commercial expansion). Although according to § 1-102 contracting parties may not disclaim the obligation to perform in good faith, § 1-102 allows contracting parties to define the requirements of good faith performance within the terms of a contract. *Id.* at § 1-102(3). Courts have held that if a lender's behavior conforms with the express terms of the lending agreement, the lender has not breached the lender's implied duty of good faith. See *Flagship Nat'l Bank v. Gray Distrib. Sys., Inc.*, 485 So. 2d 1336, 1340 (Fla. Dist. Ct. App. 1986) (holding that U.C.C. § 1-203's good faith obligation does not apply to demand notes); *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (Ct. App. 1980) (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (holding that § 1-203's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); but see *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (relying on U.C.C. § 2-309 to alter express contract provision which allowed lender to deny borrower's requests for advances against borrower's line of credit without prior notice to borrower).

13. See Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666, 671-73 (1963) (discussing drafters' adoption of flexible good faith standard to facilitate commerce).

14. U.C.C. § 1-201(19) (1987). The Official Comment to § 1-201(19) of the U.C.C. suggests that whenever the drafters of the U.C.C. used the term "good faith," the drafters implied at least the standard that § 1-201(19) sets forth. U.C.C. § 1-201(19) comment 19 (1987).

15. See U.C.C. § 1-203 (1987) (imposing obligation of good faith performance upon all parties to every contract that the U.C.C. governs); see generally Farnsworth, *supra* note 13, at 671-73 (noting that § 1-203 extends good faith provisions to all contracts that U.C.C. governs); Summers, "Good Faith" in *General Contract Law and Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968) (discussing generally interaction of U.C.C.'s good faith provisions).

standards of good faith for particular types of commercial transactions.<sup>16</sup> For example, section 1-208 of the U.C.C. specifically imposes a good faith obligation upon a lender's exercise of the lender's contractual right to accelerate a borrower's debt.<sup>17</sup> Similarly, section 2-309(3) of the U.C.C. specifically imposes a good faith obligation upon a party to a contract to provide reasonable prior notice to the other party to the contract of the party's decision to terminate the contract.<sup>18</sup>

Article 3 of the U.C.C. specifically addresses the relationship between commercial lenders and borrowers.<sup>19</sup> Article 3 categorizes contractual agreements between lenders and borrowers either as instruments that are payable on demand (demand notes), or as instruments that are payable at a definite time (time notes).<sup>20</sup> Section 3-108 describes demand notes as instruments that contain provisions that require payment upon sight or upon presentation, or as instruments that fail to state a specific time for payment.<sup>21</sup> Section 3-109(1) describes time notes as instruments which require payment on or before a stated date, within a fixed period after a stated date, within a fixed period after sight, at a definite time subject to acceleration, or at a definite time subject to extension.<sup>22</sup>

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16. See Farnsworth, *supra* note 13, at 667 (noting that U.C.C. mentions good faith in at least fifty of 400 U.C.C. sections); see *infra* notes 17-18 and accompanying text (discussing § 1-208's specific good faith obligation that governs lender's right to accelerate borrower's debt and § 2-309's specific good faith obligation that governs party's right unilaterally to terminate contract).

17. See U.C.C. § 1-208 (1987) (imposing good faith obligation upon lender's right to accelerate debt). Section 1-208 states that the acceleration clause phrases "at will" and "when he deems himself insecure" mean that the lender may accelerate when the lender in good faith believes that the borrower's ability to repay the borrower's obligation to the lender has been impaired. *Id.*

18. See U.C.C. § 2-309(3) (1987) (imposing good faith obligation upon party that terminates contract). Section 2-309(3) applies the obligation of good faith to a party's right to terminate a contract by requiring that the terminating party give notice of such termination to the other party to the contract prior to the unilateral termination of the contract. *Id.* By requiring prior reasonable notice of termination, § 2-309 grants the other party to the contract reasonable time to seek a substitute for the present contract. *Id.* In addition to requiring notice before a party unilaterally may terminate a contract, § 2-309(3) invalidates an agreement to dispense with notice prior to termination if such agreement is unconscionable. *Id.*

19. See U.C.C. § 3-104 (1987) (stating that Article 3 governs negotiable instruments including drafts, checks, certificates of deposit and notes).

20. See U.C.C. § 3-104(1)(c) (1987) (stating that negotiable instruments are either payable upon demand or payable at definite time).

21. U.C.C. § 3-108 (1987). Instruments expressly payable on demand are also demand instruments. 5 R. ANDERSON, UNIFORM COMMERCIAL CODE § 3-108:4 (3d ed. 1984).

22. U.C.C. § 3-109(1) (1987). A note also is payable at a definite time when payment is made in periodic installments. 5 R. ANDERSON, *supra* note 21, at § 3-109:5.

In addition, lenders recently have used a note that combines the features of both time and demand notes. See West & Haggerty, *The "Demandable" Note and the Obligation of Good Faith*, 21 U.C.C. L.J. 99, 113 (1988) (recognizing emergence of notes that contain features of both demand and time notes). Because Article 3 of the U.C.C. does not address notes containing both demand features and acceleration features ("demandable" notes), courts have struggled to determine the appropriate standard by which to judge a lender's collection

After classifying contractual relationships between borrowers and lenders either as demand notes or as time notes, the U.C.C. restricts a lender's discretion in seeking a borrower's repayment under the terms of a time note.<sup>23</sup> For example, lenders generally include in time notes a provision that reserves a lender's right to accelerate the due date of the borrower's debt (acceleration clause).<sup>24</sup> Similarly, lenders generally include in demand notes provisions that grant the holder of the demand note a right to demand that the borrower repay the entire loan at any time (demand clause).<sup>25</sup> Unlike the holder of a demand note, who has an unrestricted right to demand repayment of the balance due on the note, under section 1-208 a lender may exercise its contractual right to accelerate a time note only if the lender believes in good faith that the borrower will be unable to repay the note in full.<sup>26</sup> Courts generally agree that section 1-208's obligation of good faith and fair dealing applies to a creditor's decision to accelerate a time note.<sup>27</sup>

Although courts generally have found that section 1-208 requires a lender to have a good faith belief that the borrower's ability to repay the debt has been impaired before the lender accelerates a time note, courts disagree whether the good faith provisions of sections 1-208 and 1-203 apply to a lender's decision to call a demand note.<sup>28</sup> For example, in *Fulton*

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behavior under the terms of a "demandable" note. *See id.* at 113 (noting that courts have treated "demandable" notes inconsistently because acceleration and default clauses conflict with demand character of notes).

23. *See* U.C.C. § 1-208 (1987) (limiting lender's right to accelerate time note to situations in which lender believes in good faith that lender's prospect of receiving full repayment is in jeopardy); *supra* note 17 and accompanying text (discussing good faith limitation that § 1-208 imposes upon lender's right to accelerate time note).

24. *See supra* note 22 and accompanying text (describing U.C.C.'s requirements for classification of instrument as time note); *see* E. REED, R. COTTER, E. GILL, & R. SMITH, *COMMERCIAL BANKING* 332 (2d ed. 1980) (describing significant feature of time note as inclusion of acceleration clause); *see also* 5 R. ANDERSON, *supra* note 17, at § 3-109:24 (stating that although acceleration clause may state that clause operates automatically upon borrower's breach of any provision of contract, lender must perform positive act to accelerate due date of time instrument).

25. *See supra* note 21 and accompanying text (describing U.C.C.'s requirements for classification of instrument as demand note); West & Haggerty, *supra* note 22, at 104-07 (describing significant features of demand notes).

26. *See* U.C.C. § 1-208 (1987) (imposing good faith limitation on lender's right to accelerate time notes). *See supra* notes 17, 23 and accompanying text (describing § 1-208's limitations on lender's right to accelerate debt at will).

27. *See, e.g.,* *Brown v. AVEMCO Inv. Corp.*, 603 F.2d 1367, 1375 (9th Cir. 1979) (stating that lender's exercise of contractual right to accelerate borrower's debt upon borrower's breach of contract term constituted breach of lender's obligation of good faith because lender did not have good faith belief that borrower would not repay debt in accordance with § 1-208); *Smith v. Union State Bank*, 452 N.E.2d 1059, 1064 (Ind. Ct. App. 1983) (holding that § 1-208's good faith obligation limits lender's right to accelerate debts to instances in which lender believes in good faith that lender's prospect of full repayment is impaired); *State Bank v. Woolsey*, 365 P.2d 413, 417-18 (Utah 1977) (holding that § 1-208's good faith obligation applies to lender's decision to accelerate borrower's debt).

28. *See* *Flagship Nat'l Bank v. Gray Distrib. Sys. Inc.*, 485 So.2d 1336, 1340 (Fla. Dist.

*National Bank v. Willis Denney Ford*<sup>29</sup> the Georgia Court of Appeals examined whether section 1-208's good faith requirement applied to a lender's decision to call a demand note.<sup>30</sup> In *Fulton National Bank Willis Denney Ford (WDF) and Fulton National Bank* entered into a floor plan financing agreement.<sup>31</sup> Under the financing agreement, Fulton National Bank financed WDF's purchase of automobiles from Ford Motor Company.<sup>32</sup> According to the terms of the floor plan financing agreement, WDF executed a demand promissory note payable to Fulton National Bank for the purchase price of each vehicle WDF purchased from Ford Motor Company.<sup>33</sup> After WDF executed the note payable to Fulton National Bank, Fulton National Bank remitted the vehicles' purchase price to Ford Motor Company on behalf of WDF.<sup>34</sup> The terms of the financing agreement in *Fulton National Bank* required that WDF pay Fulton National Bank the amount due on each note upon WDF's sale of a financed vehicle.<sup>35</sup> In 1974 Fulton National Bank discovered that WDF had failed to extinguish the debt for each vehicle upon WDF's sale of the vehicle according to the terms of the financing agreement.<sup>36</sup> Because WDF failed to comply with the terms of the financing

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Ct. App. 1986) (holding that § 1-203's good faith obligation does not apply to demand notes); *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (Ct. App. 1980) (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Center Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (holding that § 1-203's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank*, 10 Wash. App. 530, 536, 518 P.2d 734, 738 (holding that § 1-203's good faith obligation does not apply to demand notes), *review denied*, 83 Wash. 2d 1013, *cert. denied*, 419 U.S. 967 (1974). *But see* *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 12 (1st Cir. 1987) (holding that lender in calling borrower's demand note breached good faith obligation that § 1-208 and § 1-203 imposed upon lender).

29. 154 Ga. App. 846, 269 S.E.2d 916 (Ct. App. 1980).

30. *Fulton Nat'l Bank v. Willis Denney Ford*, 154 Ga. App. 846, 269 S.E.2d 916 (Ct. App. 1980).

31. *Id.* at 846, 269 S.E.2d at 916. In *Fulton National Bank*, Willis Denney Ford (WDF) and Fulton National Bank entered into a financing agreement to purchase inventory for WDF's automobile dealership. *Id.*

32. *Id.* at 846, 269 S.E.2d at 916.

33. *Id.* at 846, 269 S.E.2d at 917.

34. *Id.* at 846, 269 S.E.2d at 916-17. In *Fulton National Bank* when Willis Denney Ford (WDF) received automobiles from Ford Motor Company (Ford), Ford presented a sight draft to the bank for the wholesale price of the vehicles that Ford delivered to WDF. *Id.* After WDF executed a promissory note and security agreement in favor of Fulton National Bank covering each automobile that WDF received from Ford, the bank paid the sight draft. *Id.*

35. *Id.* at 846, 269 S.E.2d at 917. In *Fulton National Bank* the bank maintained a security interest in each vehicle that WDF sold until WDF remitted payment to Fulton National Bank. *Id.*

36. *Id.* at 846, 269 S.E.2d at 917. In *Fulton National Bank* according to the terms of the financing agreement between Fulton National Bank and WDF, the bank conducted periodic audits of WDF's inventory to confirm that WDF possessed each vehicle in which Fulton National Bank maintained a security interest. *Id.* During the March 1974 audit of WDF's inventory, the bank discovered that WDF had sold 56 of the vehicles in which the bank



agreement, Fulton National Bank terminated the financing agreement and demanded full payment of the balance outstanding on WDF's line of credit.<sup>37</sup>

Two years after Fulton National Bank demanded full payment from WDF, WDF and WDF's president, Willis Denney, maintained an action against Fulton National Bank in the Superior Court of Fulton County.<sup>38</sup> In WDF's and Denney's action against Fulton National Bank, WDF and Denney sought to recover damages that WDF suffered when the bank terminated WDF's floor plan financing agreement.<sup>39</sup> Alleging that WDF had no viable basis for WDF's action, Fulton National Bank moved for summary judgment.<sup>40</sup> In response to Fulton National Bank's motion, the Superior Court of Fulton County held that a genuine issue of material fact existed over whether Fulton National Bank had a duty to act in good faith in exercising the bank's right under the terms of the loan agreement to demand repayment of WDF's loan.<sup>41</sup> Accordingly, the trial court denied Fulton National Bank's motion for summary judgment.<sup>42</sup> Although the court in *Fulton National Bank* denied Fulton National Bank's motion for summary judgment, the court granted Fulton National Bank's request for an interlocutory appeal to the Georgia Court of Appeals on the issue of good faith.<sup>43</sup>

On appeal, Fulton National Bank argued that section 1-208's good faith obligation did not apply to the holders of demand notes.<sup>44</sup> The Georgia Court of Appeals in *Fulton National Bank* reversed the lower court's holding that an issue of material fact existed over whether the obligation under the U.C.C. to perform contractual duties in good faith extends to the holder of a demand instrument.<sup>45</sup> In determining that the trial court should have

possessed a security interest without remitting to the bank the balance that WDF owed to the bank for each vehicle. *Id.* WDF owed Fulton National Bank over \$180,000 for the 56 vehicles that WDF sold without the bank's knowledge. *Id.*

37. *Id.* at 847, 269 S.E.2d at 917. In *Fulton National Bank*, officials of Fulton National Bank met with Willis Denney, the president of WDF, on several occasions to discuss proposed changes in WDF's operating procedures to avoid any future breach on WDF's part. *Id.* When Denney refused to agree to the bank's proposed changes, the bank gave WDF written notice of the bank's demand for immediate payment of all of WDF's outstanding demand notes. *Id.* WDF secured financing with Ford Motor Credit Company and fully satisfied WDF's indebtedness to Fulton National Bank. *Id.*

38. *See id.* at 848, 269 S.E.2d at 918 (discussing WDF's action for damages against Fulton National Bank).

39. *See id.* at 848, 269 S.E.2d at 917 (discussing WDF's allegations in WDF's action against Fulton National Bank).

40. *Id.* at 848, 269 S.E.2d at 918.

41. *See id.* at 848, 269 S.E.2d at 918 (discussing Georgia Court of Appeals' holding in WDF's action against Fulton National Bank).

42. *Id.*

43. *Id.*

44. *See id.* at 848, 269 S.E.2d at 918 (discussing Fulton National Bank's argument that holder of demand note's decision to call demand note is not subject to obligation of good faith that § 1-208 of U.C.C. imposes).

45. *See id.* (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand).

granted Fulton National Bank's motion for summary judgment, the *Fulton National Bank* court reasoned that Fulton National Bank's good faith or lack of good faith in terminating the floor plan agreement between WDF and the bank did not present to the court a genuine issue of material fact.<sup>46</sup> In reaching this decision, the Georgia Court of Appeals reasoned that section 1-208's good faith obligation did not apply to the demand notes that governed the relationship between the bank and WDF because the very nature of a demand note permits the holder of the demand note to call the borrower's obligation at any time.<sup>47</sup> After acknowledging that demand notes are by nature immediately payable, the court in *Fulton National Bank* concluded that imposing a good faith obligation upon the lender would alter the nature of the original loan agreement between the lender and the borrower.<sup>48</sup>

In addition to refusing to apply section 1-208 to the demand provision of the note, the *Fulton National Bank* court also rejected WDF's claim that the obligation of good faith in section 1-203 imposes a general obligation on lenders to act in good faith in all credit transactions.<sup>49</sup> In rejecting WDF's claim that section 1-203's good faith obligation applies to lenders in all credit transactions, the Georgia Court of Appeals reasoned that section 1-203 extends the duty to act in good faith only to obligations that a contract does not address directly.<sup>50</sup> The court refused to apply section 1-203 to the loan agreement between Fulton National Bank and WDF because specific contract terms regulated Fulton National Bank's right to demand repayment of WDF's loan.<sup>51</sup> The court further acknowledged that section 3-122 of Georgia's Commercial Code states that the sole duty of a holder of a demand instrument is to seek repayment of the borrower's obligation within the applicable statute of limitations.<sup>52</sup> Because Fulton National Bank exercised the right to demand repayment within the applicable statute of limitations, the court held that WDF successfully could not assert that

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46. See *id.* at 848-49, 269 S.E.2d at 919 (reasoning that § 1-208's good faith obligation did not apply to the demand notes because nature of demand note permits holder of demand note to call borrower's obligation at any time).

47. See *id.* (finding that § 1-208 of U.C.C. does not apply to demand notes).

48. See *id.* (concluding that § 1-208's good faith obligation does not apply to demand notes).

49. See *id.* (rejecting argument that § 1-203's good faith obligation limits lender's contractual right to demand repayment). In *Fulton National Bank* the Georgia Court of Appeals noted that WDF failed to consider that a demand note is immediately due without prior notice or demand by the lender. *Id.*

50. See *id.* (refusing to apply § 1-203 to obligations that loan agreement between Fulton National Bank and WDF directly addressed).

51. See *id.* (refusing to apply § 1-203 to loan agreement between Fulton National Bank and WDF because specific terms of contract granted Fulton National Bank right to demand repayment of WDF's loan).

52. See *id.* (discussing duties of holders of demand notes under Georgia's Commercial Code); see also Ga. Code Ann. § 109A-3-122(1)(b) (stating that sole duty of holder of demand note is to initiate action to collect debt that borrower owed to holder of note within applicable statute of limitations period).

Fulton National Bank acted in bad faith in calling WDF's loan.<sup>53</sup> Finally, the court in *Fulton National Bank* determined that applying an obligation of good faith to the demand provision in the contract between WDF and Fulton National Bank would require Fulton National Bank to surrender a right that the bank had acquired as a result of free and fair bargaining.<sup>54</sup>

Similarly, in *Centerre Bank v. Distributors, Inc.*<sup>55</sup> the Missouri Court of Appeals for the Western District of Missouri considered whether section 1-208 applied to a lender's right to call a demand note.<sup>56</sup> In *Centerre Bank Distributors, Inc. (Distributors)* and Centerre Bank executed a financing agreement in 1979 in which Centerre Bank provided Distributors a \$900,000 line of credit.<sup>57</sup> The line of credit provided operating capital for Distributors, which was a supplier of kitchen appliances to builders in the Kansas City area.<sup>58</sup> The terms of the financing agreement that Distributors and Centerre Bank executed required that Distributors sign a promissory note payable to Centerre Bank upon Centerre Bank's demand.<sup>59</sup> Because of a depression in the building industry in 1979 and 1980, Distributors' financial condition deteriorated.<sup>60</sup> In August 1981 Centerre Bank notified Distributors that Centerre Bank intended to discontinue Centerre Bank's credit relationship with Distributors.<sup>61</sup> Because Distributors was unable to secure an alternative

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53. *Fulton Nat'l Bank v. Willis Denney Ford*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (Ct. App. 1980). The court in *Fulton National Bank* concluded that WDF had no basis to contest the bank's decision to demand repayment if the bank demanded repayment within the period of time that the statute of limitations allowed for demand of repayment because the contract specifically granted Fulton National Bank the right to demand repayment at any time. *Id.*

54. *Id.* In *Fulton National Bank* the Georgia Court of Appeals stated that WDF's signature on the demand note evidenced WDF's acceptance of the demand provision. *Id.* The court in *Fulton National Bank* further stated that because WDF freely signed the note containing a clause that gave Fulton National Bank an unqualified right to demand repayment of WDF's loan, WDF had no ground to contest Fulton National Bank's decision to call WDF's note. *Id.*

55. 705 S.W.2d 42 (Mo. Ct. App. 1985).

56. *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 46 (Mo. App. 1985).

57. *Id.* at 44.

58. *Id.*

59. *Id.* In *Centerre Bank* the bank loan agreement between Centerre Bank and Distributors provided that Distributors would pledge all of Distributors' accounts receivable and inventory to secure the \$900,000 line of credit. *Id.*

60. *Id.* at 45. In *Centerre Bank* Distributors' 1979 financial statement indicated a loss in excess of \$100,000. *Id.* Upon receipt of Distributors' 1979 financial statement, Centerre Bank placed Distributors' loan on Centerre Bank's problem loan list. *Id.* This action by Centerre Bank indicated that Centerre Bank considered Distributors' loan to have a high probability of loss. *See id.* (discussing Distributors' financial condition prior to Centerre Bank's decision to call Distributors' loan).

61. *Id.* In addition to the weakening financial condition of Distributors in *Centerre Bank*, Centerre Bank was also concerned about the deterioration of Centerre Bank's collateral for the loan. *Id.* Because of the depressed state of the building industry, Centerre Bank conservatively deemed at least 14 percent of Distributors' receivables uncollectible at the time that Centerre Bank terminated Distributors' line of credit. *Id.* at 46. In addition, Centerre Bank was concerned that Distributors' inventory estimates were inaccurate. *Id.*

source of financing, Distributors surrendered the assets of Distributors to Centerre Bank in partial satisfaction of Distributors' debt to Centerre Bank.<sup>62</sup> After liquidating Distributors' assets and applying the proceeds of the liquidation sale to Distributors' loan balance, Centerre Bank filed a complaint against Distributors in the Circuit Court of Jackson County.<sup>63</sup> In Centerre Bank's complaint, Centerre Bank sought recovery of the balance of Distributors' loan from Distributors and various guarantors of the demand note.<sup>64</sup> In response, Distributors filed a counterclaim against Centerre Bank.<sup>65</sup> Distributors' counterclaim alleged that Centerre Bank's demand of repayment of the entire loan balance breached Centerre Bank's general obligation of good faith that section 1-203 implied in the loan agreement between Distributors and the bank.<sup>66</sup> Distributors contended that in demanding repayment of the note, Centerre Bank failed to act in good faith because Centerre Bank's loan officers led Distributors to believe that the bank was willing to work with Distributors to restructure Distributors' loan and that Distributors' management relied upon the bank's representations when Distributors' management made financial decisions.<sup>67</sup> The Circuit Court entered a judgment for Distributors on the counterclaim.<sup>68</sup> Centerre Bank appealed the trial court's ruling to the Missouri Court of Appeals for the Western District of Missouri.<sup>69</sup> On appeal, Centerre Bank contended that the trial court erred in allowing Distributors to assert that Centerre

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62. *Id.* In *Centerre Bank* even after Centerre Bank called Distributors' loan, bank officers met with venture capitalists in an attempt to obtain financing for Distributors. *Id.* When this effort appeared futile, the bank took possession of Distributors' assets. *Id.* The bank collected Distributors' accounts receivable and liquidated Distributors' remaining inventory. *Id.*

63. *Id.* at 44.

64. *Id.* In the collection action that Centerre Bank filed against Distributors in *Centerre Bank*, the bank sought to recover from Distributors \$227,594.22 due on Distributors' note, interest of \$100,510.04, and collection expenses of \$18,537.22. *Id.* Centerre Bank also filed an action against the guarantors of Distributors' loan. *Id.*

65. *Id.*

66. *See id.* at 46 (discussing Distributors' claims in Distributors' counterclaim against Centerre Bank in lower court).

67. *See id.* at 46-47 (discussing Distributors' claims that loan officers of Centerre Bank led Distributors' management to believe that Distributors' loan was not in jeopardy of being called just prior to Centerre Bank's demand). Despite Distributors' claims in *Centerre Bank* that Centerre Bank's loan officers had misled Distributors' management concerning the bank's attitude toward Distributors' loan, Dan Brown, Distributors' General Manager, testified that on at least two occasions Centerre Bank's loan officers informed Brown that Centerre Bank's continued financing of Distributors was subject to loan committee approval. *Id.* at 49-50.

68. *Id.* at 44. The jury in *Centerre Bank* determined that Centerre Bank failed to exercise good faith in calling Distributors' loan. *Id.* Accordingly, the jury in *Centerre Bank* awarded Distributors and the other defendants in the suit a total of \$7,528,800 in actual and punitive damages for fraudulent misrepresentation and nondisclosure. *Id.* In *Centerre Bank* the Missouri Court of Appeals remitted half of the \$6 million punitive damage award and entered a \$4,528,800 judgment against Centerre Bank on Distributors' counterclaim. *Id.*

69. *Id.* In *Centerre Bank* Distributors appealed the remittitur of the punitive damages. *Id.* Because the Missouri Court of Appeals reversed the damages judgement against Centerre Bank, the court no longer needed to decide the validity of the remittitur issue. *Id.*

Bank lacked good faith in initiating its collection action against Distributors.<sup>70</sup>

On appeal, the Missouri Court of Appeals reversed the circuit court's holding that Centerre Bank breached Centerre Bank's duty under section 1-203 to perform contractual obligations in good faith.<sup>71</sup> In addressing Distributors' claim that the U.C.C. imposed upon Centerre Bank a duty to perform in good faith when Centerre Bank called Distributors' demand note, the Court of Appeals reasoned that because Centerre Bank included an unqualified demand provision in the promissory note that Distributors signed, the promissory note provided evidence that Centerre Bank and Distributors had established a relationship in which Centerre Bank retained unfettered discretion to demand payment of the entire balance of Distributors' loan.<sup>72</sup> After considering the reasoning of the court in *Fulton National Bank*, the Missouri Court of Appeals in *Centerre Bank* determined that section 1-203's good faith obligation had no application to demand notes because section 1-203's good faith obligation would add a term to the agreement that the parties did not include in the original agreement.<sup>73</sup>

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70. See *id.* (discussing Centerre Bank's argument that court erred in allowing Distributors to assert that Centerre Bank lacked good faith in calling note as defense to Centerre Bank's suit to collect unpaid balance of demand note).

71. See *id.* (reversing lower court's ruling that Centerre Bank lacked good faith in calling Distributors' loan).

72. See *id.* at 48 (discussing significance of provision in loan agreement between Distributors and Centerre Bank).

73. See *id.* at 47-48 (echoing reasoning of Georgia Court of Appeals in *Fulton National Bank* that imposing good faith obligation upon lender's explicit right to demand repayment would alter agreement between lender and borrower). The court in *Centerre Bank* expressed an unwillingness to rewrite the terms of the original loan agreement that the contracting parties initially negotiated. *Id.*

After the decisions in *Fulton National Bank* and *Centerre Bank* the United States District Court for the Eastern District of Arkansas in *Taggart & Taggart Seed v. First Tennessee Bank*, 684 F. Supp. 230 (E.D. Ark. 1988), *aff'd*, 1989 WL 87802 (8th Cir. 1989) examined whether the U.C.C.'s covenant of good faith applied to a demand instrument. In *Taggart* First Tennessee Bank (First Tennessee) and Taggart & Taggart Seed Co. (Taggart) executed a loan agreement in which First Tennessee provided Taggart an \$18 million secured line of credit. *Id.* at 232. Under the terms of the financing agreement that Taggart and First Tennessee executed, First Tennessee reserved the right to demand payment of the entire outstanding balance of Taggart's loan. *Id.* at 235. In addition to reserving the right to demand full payment of the loan without prior notice to Taggart of First Tennessee's intention to call the loan, First Tennessee also reserved the right to refuse to advance funds to Taggart without prior notice to Taggart. *Id.* In *Taggart* First Tennessee held as a portion of the collateral for Taggart's loan United States Department of Agriculture warehouse receipts for grain that Taggart stored in silos on Taggart's property. *Id.* at 232. Under the terms of the loan agreement that Taggart executed with First Tennessee, Taggart could not remove the grain from storage until First Tennessee received payment from Taggart for the stored grain and released the warehouse receipts. *Id.* After discovering that Taggart, without first paying First Tennessee, had removed from storage a portion of the grain that secured Taggart's loan with First Tennessee, First Tennessee demanded repayment of the outstanding balance of Taggart's line of credit with First Tennessee. *Id.* In response to First Tennessee's demand, Taggart obtained a replacement line of credit from another lender and honored First Tennessee's demand for

Not all courts, however, have accepted the rationale of the courts in *Fulton National Bank* and *Centerre Bank* that the good faith requirement of sections 1-208 and 1-203 does not apply to demand instruments.<sup>74</sup> For example, in *Reid v. Key Bank of Southern Maine* the United States Court of Appeals for the First Circuit considered whether an obligation of good faith applied to a lender's decision to demand repayment under the terms of a loan agreement.<sup>75</sup> In *Reid*, Paul Reid and Depositors Trust Co. of Southern Maine (Depositors Trust), Key Bank's predecessor in interest, entered into a financing arrangement in which Depositors Trust provided to Reid a \$25,000 secured line of credit.<sup>76</sup> The line of credit provided working capital for Reid's paint subcontracting business.<sup>77</sup> Under the terms of the financing agreement, Depositors Trust reserved the right to demand

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repayment. *Id.*

In *Taggart* several months after Taggart honored First Tennessee's demand for repayment of the outstanding balance of Taggart's line of credit with First Tennessee, Taggart filed an action against First Tennessee in the United States District Court for the Eastern District of Arkansas. *Id.* In Taggart's action against First Tennessee, Taggart alleged that First Tennessee's failure to continue a credit relationship with Taggart pursuant to First Tennessee's loan agreement with Taggart constituted a breach of the covenant of good faith that § 1-208 of the U.C.C. implied in the loan agreement. *Id.* In moving for summary judgment, First Tennessee argued that a borrower may not invoke § 1-208's good faith requirement to block a lender's unilateral decision to terminate a demand note. *Id.* The court in *Taggart* agreed with First Tennessee that because the loan agreement that governed Taggart's line of credit with First Tennessee specifically stated that any outstanding balance on the line of credit was repayable on demand, § 1-208's good faith requirement did not create a genuine issue of material fact. *Id.* at 235-36. The district court subsequently granted First Tennessee's motion for summary judgment. *Id.* at 239. In ruling in favor of First Tennessee, the *Taggart* court relied upon the reasoning of the Georgia Court of Appeals in *Fulton National Bank* and the reasoning of the Missouri Court of Appeals in *Centerre Bank*. *Id.* at 236. In addition to relying on the reasoning of the *Fulton National Bank* court and the *Centerre Bank* court, the court in *Taggart* also relied upon the official comment to § 1-208 of the U.C.C. which states that § 1-208 obviously does not apply to demand notes because holders of demand notes reserve the right to call the notes at any time without reason. *Id.* at 235-36. After noting that First Tennessee's right to call the loan was a significant element of First Tennessee's credit relationship with Taggart, the *Taggart* court further stated that absent clear and convincing evidence that Taggart presented to demonstrate First Tennessee's fraudulent behavior, the court would not alter the stated contract terms. *Id.* at 236.

74. See *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 12 (1st Cir. 1987) (holding that lender, in calling borrower's demand note breached good faith obligation of §§ 1-208 and 1-203); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985) (stating in dicta that demand clause is type of acceleration clause to which good faith obligation of § 1-208 applies); *infra* notes 39-52 and 66-71 and accompanying text (discussing Georgia Court of Appeals' and Missouri Court of Appeals' rejection of application of § 1-208's good faith obligation to demand notes in *Fulton National Bank* and *Centerre Bank*).

75. 821 F.2d 9 (1st Cir. 1987).

76. *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 11 (1st Cir. 1987). According to the terms of the loan agreement in *Reid*, Reid pledged his personal vehicle, a commercial vehicle, and the accounts receivable of Reid's painting business as security for the line of credit that Reid obtained from Depositors Trust. *Id.*

77. *Id.* Reid sought the line of credit from Depositors Trust in *Reid* primarily to finance one large contract that Reid obtained. *Id.*

payment of the entire principal balance of Reid's loan at any time.<sup>78</sup> According to the financing agreement between Reid and Depositors Trust, Reid agreed to make quarterly interest payments on the outstanding balance on the line of credit.<sup>79</sup> When Reid failed to make an interest payment on the line of credit, Depositors Trust notified Reid of his failure to make the required quarterly interest payment.<sup>80</sup> When Reid failed to respond to Depositor Trust's communications, Depositors Trust repossessed the vehicles that secured Reid's loan.<sup>81</sup> Immediately after Depositors Trust repossessed Reid's personal automobile and commercial van, Reid's business collapsed forcing Reid to file bankruptcy.<sup>82</sup>

After Reid's painting business collapsed, Reid brought an action against Depositors Trust in the United States District Court for the District of Maine.<sup>83</sup> Reid alleged that Depositors Trust acted in bad faith in terminating the lending arrangement between Reid and Depositors Trust and in demanding payment in full of the outstanding balance on Reid's loan.<sup>84</sup> The jury found that Depositors Trust breached both section 1-203's and section 1-208's covenants of good faith and fair dealing and awarded Reid \$100,000 in compensatory damages and \$500,000 in exemplary damages.<sup>85</sup> The district court in *Reid* struck the jury's award of exemplary damages.<sup>86</sup> Both Reid and Depositors Trust appealed the district court's ruling to the United States Court of Appeals for the First Circuit.<sup>87</sup>

On appeal, the First Circuit in *Reid* affirmed the district court's holding that Depositors Trust breached both section 1-203's general obligation of good faith and fair dealing and section 1-208's specific requirement that a

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78. *See id.* at 13 (noting that "Secured Interest Note" that Reid executed contained unambiguous demand clause).

79. *Id.*

80. *Id.* at 11. In *Reid* when Reid failed to make the September 5, 1979, interest payment that the loan agreement between Reid and Depositors Trust required, Depositors Trust sent Reid a past-due notice. *Id.* Depositors Trust sent the past-due notice to Reid on September 20, 1979. *Id.*

81. *Id.* After Depositors Trust repossessed Reid's personal and commercial vehicle in *Reid*, Reid discovered one of the repossessed vehicles in a parking lot and attempted to retrieve the vehicle. *Id.* The police arrested Reid for Reid's attempted retrieval of the repossessed vehicle. *Id.* Reid later testified that he was unaware that Depositors Trust had repossessed the vehicle and thought that someone had stolen the vehicle. *Id.*

82. *Id.* In *Reid* when Reid's business failed Reid lost four vehicles and his home. *Id.*

83. *See id.* at 10 (discussing Reid's action in United States District Court for the District of Maine in *Reid*).

84. *Id.* In *Reid* in addition to alleging that Depositors Trust demanded repayment in bad faith, Reid alleged that Depositors Trust interfered with Reid's contractual relationships with other parties and wrongfully dishonored Reid's checks. *Id.* at 12. Reid further alleged that racial prejudice motivated Depositors Trust's bad faith toward Reid. *Id.* at 11.

85. *See id.* at 12 (discussing jury's award of damages to Reid due to Depositors Trust's breach of obligation of good faith).

86. *See id.* (noting that District Court of Maine struck exemplary damages). In *Reid* the First Circuit stated that Depositors Trust's breach of obligation of good faith was not a tort for which Maine law provided exemplary damages. *Id.* at 16.

87. *Id.* at 11.

lender exercise good faith when accelerating a borrower's debt.<sup>88</sup> The First Circuit found that evidence of Depositors Trust's failure to take account of Reid's financial problems by negotiating an alternative solution to calling Reid's loan supported the jury's finding that Depositors Trust's treatment of Reid lacked good faith.<sup>89</sup> Depositors Trust, however, argued that section 1-208 applied only to acceleration clauses.<sup>90</sup> Depositors Trust further argued that financing agreements that contain demand clauses preclude courts from finding that the lenders in the agreements owe the borrowers a duty of good faith when the lenders demand repayment of the notes.<sup>91</sup> Depositors Trust argued that the good faith provisions of the U.C.C. do not apply to demand notes because applying the good faith obligation to a demand provision would alter the nature of the original agreement.<sup>92</sup> In response to Depositors Trust's argument that the U.C.C.'s good faith obligations did not apply to the demand note that Reid and Depositors Trust had executed, the First Circuit in *Reid* held that Depositors Trust maintained only a qualified right to enforce the demand provision of the note because a separate document relating to the security interest that Depositors Trust maintained in collateral as security for the line of credit between Reid and Depositors Trust mentioned the event of default.<sup>93</sup> The First Circuit found that the separate document mentioning the event of default prevented the demand clause in the loan agreement from being an unequivocal demand provision, and, therefore, held that the financing agreement between Reid and Depositors Trust did not constitute a demand note.<sup>94</sup> Accordingly, the First Circuit in *Reid* held that section 1-208's covenant of good faith and

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88. *See id.* at 13 (stating that lower court in *Reid* correctly applied good faith obligation of §§ 1-203 and 1-208 to loan agreement between Reid and Depositors Trust).

89. *See id.* at 15 (stating that Depositors Trust did not make a good faith effort to find solution to problems that Depositors Trust perceived in Depositors Trust's relationship with Reid). On appeal the First Circuit in *Reid* also held that Depositors Trust's failure to give Reid sufficient notice that Depositors Trust intended to terminate the credit relationship between Reid and Depositors Trust evidenced Depositors Trust's bad faith in dealing with Reid. *Id.*

90. *Id.* at 13.

91. *See id.* (discussing Depositors Trust's argument against applying good faith obligation to demand notes). In *Reid* Depositors Trust contended that § 1-208 of the U.C.C. and the official comment to § 1-208 precluded the application of the U.C.C.'s good faith requirement to demand notes. *Id.*

92. *Id.*

93. *See id.* at 14 (reasoning that Depositors Trusts qualified right to demand repayment of Reid's loan warranted placing Depositors Trust under good faith obligation). After the court in *Reid* acknowledged that the demand note that Reid executed in favor of Depositors Trust contained an unambiguous demand clause, the First Circuit cited events constituting default in the security agreement as limitations upon Depositors Trust's right to demand repayment. *Id.*

94. *Id.* The First Circuit in *Reid* held that despite Reid's acceptance of the demand language found in the demand note, because the security agreement contained default provisions, Depositors Trust did not retain an unqualified right to demand repayment. *Id.*



fair dealing applied to Depositors Trust's demand of repayment in full of Reid's debt.<sup>95</sup>

In addition to focusing upon a lender's discretionary right to call a demand note, courts also have examined a lender's discretionary right to refuse to advance funds to a borrower against the borrower's line of credit.<sup>96</sup> Although the loan agreements that govern demand notes specifically state that the lender may refuse at the lender's discretion to advance funds to a borrower against the borrower's line of credit, courts have applied section 1-203's good faith obligation to limit a lender's discretionary right to refuse to advance funds against a borrower's line of credit.<sup>97</sup>

In *K.M.C. Co. v. Irving Trust Co.*,<sup>98</sup> for example, the United States Court of Appeals for the Sixth Circuit considered whether section 1-203's requirement that parties to a contract must perform in good faith limited a lender's right to advance funds against a borrower's line of credit at will and without prior notice to the borrower.<sup>99</sup> In *K.M.C. Irving Trust and K.M.C. Co.* entered into a financing agreement in which Irving Trust provided K.M.C. a \$3.5 million secured line of credit.<sup>100</sup> The line of credit provided operating capital for K.M.C.'s wholesale and retail grocery business.<sup>101</sup> Under the terms of the financing agreement, Irving Trust reserved the right to demand payment of the entire principal amount outstanding on K.M.C.'s credit line at any time without prior notice to K.M.C.<sup>102</sup> In addition to reserving the right to demand full payment of the loan without prior notice, Irving Trust also reserved the right to refuse without prior notice to advance funds to K.M.C.<sup>103</sup> Three years after K.M.C. and Irving Trust entered into the loan agreement, K.M.C.'s financial condition deteriorated and, consequently, Irving Trust refused to advance \$800,000 to K.M.C.<sup>104</sup> Because K.M.C. lacked sufficient funds to continue to operate

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95. *Id.*

96. See *supra* notes 28-93 and accompanying text (discussing courts' focus upon lenders' right to call demand notes); see *infra* notes 96-114 and accompanying text (discussing courts' focus upon lenders' right to refuse to advance funds against borrowers' line of credit).

97. See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (relying on § 2-309 of U.C.C. to alter express contract provision that allowed lender to deny borrower's requests for advances against borrower's line of credit without prior notice to borrower).

98. 757 F.2d 752 (6th Cir. 1985).

99. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985).

100. *Id.* at 754. In *K.M.C. Irving Trust* held a security interest in K.M.C.'s accounts receivable and inventory as collateral for the line of credit that Irving Trust extended to K.M.C. *Id.* Under the terms of the financing agreement, K.M.C.'s customers remitted accounts receivable payments directly to a "blocked account" that Irving Trust controlled. *Id.* at 759. Irving Trust based the advances that Irving Trust made to K.M.C. against K.M.C.'s line of credit upon the amount of K.M.C.'s receivables outstanding and the level of K.M.C.'s inventory on hand. *Id.*

101. *Id.* at 754.

102. *Id.* at 759-60.

103. *Id.* at 759.

104. *Id.* at 754. In *K.M.C.* in March 1982, Irving Trust refused to advance \$800,000 against K.M.C.'s line of credit as K.M.C. requested. *Id.* Irving Trust denied K.M.C.'s request

its wholesale and retail grocery business, K.M.C. discontinued operations.<sup>105</sup>

After discontinuing operations, K.M.C. maintained an action against Irving Trust in the United States District Court for the Eastern District of Tennessee.<sup>106</sup> K.M.C. alleged that in refusing to advance funds to K.M.C. without prior notice to K.M.C., Irving Trust breached its duty to perform in good faith under section 1-203 and that Irving Trust's breach forced K.M.C. out of business.<sup>107</sup> In addition to alleging that Irving Trust breached its duty of good faith by refusing to advance funds to K.M.C., K.M.C. further alleged that although Irving Trust had not yet exercised Irving Trust's right to call K.M.C.'s line of credit, section 1-208 would require Irving Trust to exercise good faith if Irving Trust demanded repayment of K.M.C.'s loan under the provisions of the financing agreement.<sup>108</sup> In *K.M.C.* the jury found that Irving Trust breached the duty of good faith that section 1-203 implied in the contract between K.M.C. and Irving Trust and awarded K.M.C. \$7.5 million in damages.<sup>109</sup> Irving Trust appealed the lower court's decision to the United States Court of Appeals for the Sixth Circuit.<sup>110</sup>

On appeal, the Sixth Circuit in *K.M.C.* affirmed the district court's holding that Irving Trust breached the duty of good faith performance that section 1-203 implied in the loan agreement between K.M.C. and Irving Trust.<sup>111</sup> The Sixth Circuit determined that the Magistrate correctly instructed

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because the loan officer who was responsible for K.M.C.'s loan believed that K.M.C. was relying too heavily on short term unsecured credit from suppliers and that K.M.C.'s financial condition was deteriorating. *Id.* at 762. If granted, the \$800,000 advance that K.M.C. requested would have increased K.M.C.'s loan balance to just under the \$3.5 million limit. *Id.* at 754.

105. *Id.* at 754. As a result of Irving Trust's refusal to advance funds to K.M.C., the bank dishonored checks that K.M.C. had sent to suppliers because K.M.C.'s account did not contain sufficient funds to cover all of K.M.C.'s outstanding checks. *Id.* at 759. After unsuccessfully attempting to secure another source of financing, K.M.C. discontinued operations. *Id.*

106. *See id.* at 754 (discussing K.M.C.'s action against Irving Trust in United States District Court for the Eastern District of Tennessee, in which K.M.C. alleged that Irving Trust breached its obligation of good faith in refusing to advance funds against K.M.C.'s line of credit).

107. *See id.* at 754 (discussing K.M.C.'s allegations that Irving Trust, in refusing to advance funds against K.M.C.'s line of credit, breached § 1-203's good faith obligation). In K.M.C.'s action against Irving Trust, K.M.C. alleged that by refusing to advance funds to K.M.C. without notice, Irving Trust destroyed K.M.C.'s business. *Id.* In K.M.C.'s complaint, K.M.C. requested \$12 million in compensatory damages and \$25 million in punitive damages. Plaintiff's Complaint, *K.M.C. Co. v. Irving Trust Co.*, No. CIV-3-82-365, at 8.

108. *See id.* at 760 (noting K.M.C.'s additional allegation that Irving Trust breached § 1-208's obligation of good faith in demanding full repayment of K.M.C.'s line of credit).

109. *Id.* at 755. In *K.M.C.* the jury awarded K.M.C. \$7.5 million plus interest, relying upon expert testimony regarding the damage to K.M.C.'s business that resulted from Irving Trust's breach of contract. *Id.* at 763-66.

110. *Id.* at 754.

111. *See id.* at 758-59 (stating that district court correctly held that § 1-203's good faith obligation imposed upon lender duty to give notice to borrower before lender could refuse to advance funds against borrower's line of credit).

the jury that Irving Trust owed K.M.C. an obligation to act in good faith.<sup>112</sup> In *K.M.C.* the Sixth Circuit stated that by requiring a lender to give notice to a borrower before refusing to advance funds on the borrower's line of credit, section 2-309 of the U.C.C. specifically defines the lender's obligation of good faith in situations in which the lender unilaterally terminates a line of credit.<sup>113</sup> Moreover, the Sixth Circuit in *K.M.C.* concluded that because the duty of good faith that the U.C.C. implies in every contract governed the financing agreement between K.M.C. and Irving Trust, absent a valid business reason for not giving notice to K.M.C., the good faith notice provision of section 2-309 required that Irving Trust provide notice to K.M.C. before Irving Trust refused to advance funds against K.M.C.'s line of credit.<sup>114</sup> In reaching its decision in *K.M.C.*, the Sixth Circuit reasoned that without providing sufficient notice of Irving Trust's decision to terminate K.M.C.'s line of credit, Irving Trust left K.M.C. without sufficient operating capital to survive until K.M.C. could obtain an alternative source of financing which ultimately caused K.M.C. to discontinue operating K.M.C.'s wholesale and retail grocery business.<sup>115</sup>

In addition to determining that Irving Trust could not terminate K.M.C.'s line of credit without prior notice to K.M.C., the Sixth Circuit in *K.M.C.* considered whether section 1-208's good faith obligation limited Irving Trust's contractual right to demand repayment of the entire balance of K.M.C.'s line of credit.<sup>116</sup> In response to Irving Trust's objection that the

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112. See *id.* at 759 (recounting Magistrate's instructions to jury that Irving Trust had duty to notify K.M.C. prior to refusing to advance funds against K.M.C.'s line of credit). In *K.M.C.* the Magistrate had instructed the jury that the U.C.C. implied an obligation of good faith into every contract. *Id.* The Magistrate further instructed the jury that in accordance with this obligation of good faith, Irving Trust had a duty to give K.M.C. notice before refusing to advance funds against K.M.C.'s line of credit. *Id.*

113. See *id.* (stating that § 2-309 infers that party terminating contract must provide other party to contract prior notice of intention to terminate prior to party's unilateral termination of contract). In *K.M.C.* the court applied § 2-309 of the U.C.C. to the termination provision in the loan agreement between K.M.C. and Irving Trust. *Id.*; see also U.C.C. § 2-309 (1987) (stating that U.C.C. will infer in contracts that fail to address notice prior to termination a reasonable notice requirement prior to termination).

114. See *id.* at 759 (discussing Sixth Circuit's conclusion that § 2-309 imposed upon Irving Trust good faith obligation to provide K.M.C. notice prior to Irving Trust's termination of lending relationship with K.M.C.). Although the court in *K.M.C.* did not specify what would constitute a valid business reason for withholding notice, the Sixth Circuit noted that the loan officer's belief that K.M.C. had such a severe cash flow problem that the bank could not honor all of K.M.C.'s outstanding checks upon presentment to K.M.C.'s bank even if K.M.C. received the advance that K.M.C. requested was not a sufficiently valid reason to justify Irving Trust's action. *Id.*

115. See *id.* (reasoning that Irving Trust's refusal to advance funds to K.M.C. without prior notice would leave K.M.C. without sufficient financial resources to continue operating). After noting that a medium sized grocer like K.M.C. could not operate without outside financing, the court in *K.M.C.* concluded that Irving Trust's denial of K.M.C.'s request for operating funds coupled with Irving Trust's control of K.M.C.'s incoming receivables placed K.M.C. in an impossible situation. *Id.*

116. See *id.* at 760 (applying § 1-208's good faith obligation to demand note that K.M.C. and Irving Trust executed in *K.M.C.*).

good faith standard in section 1-208 applied to acceleration clauses rather than demand clauses, the Sixth Circuit summarily stated that the demand clause was a type of acceleration clause and, therefore, that section 1-208 imposed limitations of reasonableness and fairness upon a lender's discretion to call a loan.<sup>117</sup>

As the opinions in *K.M.C.* and *Reid* indicate, courts have limited lenders' discretionary rights by using sections 2-309 and 1-208 of the U.C.C. to inject section 1-203's good faith obligation into demand notes.<sup>118</sup> By injecting section 1-203's good faith obligation into the terms of demand notes, the Sixth Circuit and the First Circuit have applied the good faith obligation to limit a lender's discretionary contractual rights in a manner contrary to the intent of the drafters of the U.C.C.<sup>119</sup> In drafting the U.C.C., the authors of the U.C.C. attempted to facilitate commerce by promoting predictability, simplicity, and uniformity in the law that governs commercial transactions.<sup>120</sup> In accordance with the goal of facilitating commerce, the drafters attempted to promote freedom of contract among commercial parties by granting deference to the express terms of written agreements.<sup>121</sup> In recognizing the importance of express contract terms, the drafters included in section 1-102(3) of the U.C.C. provisions which allow contracting parties to include in written agreements express contract terms which vary or supersede most provisions of the U.C.C.<sup>122</sup> The drafters of the U.C.C., however, also imposed upon contracting commercial parties a duty to perform contractual obligations in good faith.<sup>123</sup> Although section 1-102(3) specifically prohibits contracting parties from totally disclaiming the duty to perform contractual obligations in good faith, contracting parties

117. See *id.* at 760 (reasoning that § 1-208's good faith obligation did not apply to demand notes).

118. See *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 11 (1st Cir. 1987) (holding that in calling borrower's demand note lender breached good faith obligation of § 1-208 and § 1-203); *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985) (holding that lender in refusing to advance funds without notice against borrower's line of credit breached good faith obligation of § 2-309 and § 1-203).

119. See *infra* notes 119-56 and accompanying text (discussing intent of U.C.C. drafters and First Circuit and Sixth Circuit's contrary application of good faith obligation to demand notes).

120. See U.C.C. § 1-102(2) (1987) (stating that purpose of U.C.C. is to promote simplicity and uniformity in laws that govern commercial transactions).

121. See U.C.C. § 1-205 (1987) (establishing priority of express contract provisions in contract construction). The U.C.C. places the highest priority in contract construction on express contract terms. *Id.* Course of dealing and usage of trade follow express contract terms in importance. *Id.*; see also U.C.C. § 2-208(4) (reiterating priorities U.C.C. sets forth in § 1-205).

122. See U.C.C. § 1-102(3) (1987) (stating that contracting parties can vary U.C.C. standards of good faith performance, diligence, reasonableness and care with express contract provisions); *supra* note 13 and accompanying text (discussing contracting parties' rights to specify standard of good faith that will govern behavior of parties to contract under U.C.C.).

123. See U.C.C. § 1-203(3) (1978) (imposing obligation of good faith performance upon all parties to every contract that the U.C.C. governs).

nevertheless, are free under section 1-102(3) to determine the precise standard of good faith that will govern the contractual relationship between the contracting parties.<sup>124</sup> In light of the drafters' emphasis in contract construction on the express terms of a contract, courts may employ the U.C.C.'s duty of good faith as a tool in interpreting ambiguous contract provisions, but courts cannot apply the duty of good faith to override reasonable contract terms.<sup>125</sup>

For example, applying section 1-208 to time notes in which a lender reserves the qualified right to accelerate a borrower's debt otherwise not immediately due does not alter a lender's right to accelerate a debt under the terms of the note.<sup>126</sup> Instead, section 1-208 merely provides meaning to key terms in the acceleration clause.<sup>127</sup> In contrast, in a demand note a lender commonly bargains for the right to demand repayment of an entire loan balance at any time regardless of the lender's motive for demanding repayment in full.<sup>128</sup> Typical commercial demand agreements between parties that bargain at arms' length contain unambiguous evidence of the lenders' negotiated right to demand repayment at any time for any reason.<sup>129</sup> Applying section 1-208's good faith requirement to a lender's unambiguous contractual right to demand repayment substantially alters the terms of the commercial demand agreement.<sup>130</sup> Furthermore, in the official comment to

124. See U.C.C. § 1-102(3) (1987) (stating that although contracting parties cannot disclaim obligation of good faith, contracting parties can establish reasonable standards of good faith performance that will govern contractual relationship of parties).

125. See *id.* (stating that express contract provisions that establish reasonable good faith standards are valid standards by which courts should measure good faith performance of contracting parties); see also *Flagship Nat'l Bank v. Gray Distrib. Sys., Inc.*, 485 So. 2d 1336, 1340 (Fla. Dist. Ct. App. 1986) (holding that U.C.C. § 1-203's good faith obligation does not apply to demand notes); *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269 S.E.2d 916, 918 (1980) (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (holding that § 1-203's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); but see *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (relying on U.C.C. § 2-309 to alter express contract provision which allowed lender to deny borrower's requests for advances against borrower's line of credit without prior notice to borrower).

126. See U.C.C. § 1-208 (1987) (clarifying ambiguous acceleration clause terms of time notes). By providing meaning to acceleration clause terms "at will" and "when he deems himself insecure," § 1-208 defines rather than alters the lender's contractual right to accelerate the debt. *Id.*

127. See *id.* (stating that terms like "at will" in acceleration clauses mean that lender can accelerate debt only when lender believes in good faith that intervening circumstances have impaired borrower's ability to repay debt).

128. See 5 R. ANDERSON, *supra* note 21, at § 3-108:3 (stating that lender bargains for demand clauses that allow lender to demand repayment without regard to lender's motive for demanding repayment).

129. See *id.* (stating that typical demand note allows lender to exercise contractual right to demand repayment without regard to lender's motive for demanding repayment).

130. See *infra* notes 130-32 and accompanying text (discussing incongruity between § 1-208's good faith obligation and express demand clause in demand note).

section 1-208, the commentators to the U.C.C. recognized the incongruity between section 1-208's good faith requirement and a lender's right under the terms of a typical demand note to demand repayment in full at any time.<sup>131</sup> Because the lender's express unqualified contractual right to call a demand note conflicts with section 1-208's requirement that a lender accelerate payment of the balance of a note only if the lender has a good faith belief that circumstances have impaired the borrower's ability to pay or perform, the commentators to the U.C.C. concluded that the good faith requirement of section 1-208 did not apply to demand notes.<sup>132</sup> In reaching this conclusion, commentators to the U.C.C. noted that the nature of demand notes allows the holder of the demand instrument the unfettered right to demand repayment at any time.<sup>133</sup>

Lastly, although section 1-102(3) of the U.C.C. prohibits contracting parties from totally disclaiming the good faith obligation in a contractual relationship, section 1-102(3) allows the parties to a contract to define a reasonable standard of good faith that will govern the relationship between the contracting parties.<sup>134</sup> By negotiating repayment terms in which the lender acquires the unfettered right to demand repayment of the entire debt at any time in exchange for a flexible schedule that allows the borrower to defer all principal payments, the parties to a demand note in fact have defined the standard of good faith that will govern repayment of the borrower's debt.<sup>135</sup> Because the courts in *Fulton National Bank* and *Centerre Bank* recognized that the U.C.C. allows contracting parties the freedom to specify the required standard of good faith performance in commercial transactions, courts correctly refused to apply the good faith requirement of section 1-208 to override the express terms of the demand notes.<sup>136</sup>

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131. U.C.C. § 1-208 comment (1987). The comment to U.C.C. § 1-208 states that "obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without any reason. This section applies only to an agreement or to paper which in the first instance is payable at a future date." *Id.*

132. See *supra* note 130 and accompanying text (noting that U.C.C. commentators recognized incongruity between § 1-208's good faith obligation and lender's express right to demand repayment in full from borrower).

133. See *supra* note 130 and accompanying text (stating that U.C.C. commentators recognized that demand note grants lender right to demand repayment in full from borrower without regard to lender's motive); *supra* note 127 and accompanying text (discussing lender's right to demand repayment from borrower at any time without regard to lender's motive in demanding repayment).

134. See *supra* notes 13 and 123 and accompanying text (stating that contracting parties expressly may establish reasonable standard of good faith that will govern contractual relationship between parties).

135. See *supra* note 54 and accompanying text (stating that because parties to loan agreement freely negotiated terms of loan agreement, borrower has no ground on which to contest lender's decision to exercise lender's contractual right to call loan); *supra* notes 13, 123-24 and accompanying text (citing Georgia Court of Appeals' conclusion in *Fulton National Bank v. Willis Denney Ford, Inc.* that WDF's signature on demand note evidenced WDF's acceptance of contract terms).

136. See *Fulton Nat'l Bank v. Willis Denney Ford, Inc.*, 154 Ga. App. 846, 847, 269

In *Reid*, however, the First Circuit failed to recognize the incongruity between the good faith standard of section 1-208 and the express terms of a demand note.<sup>137</sup> The court in *Reid* stated that a literal construction of the demand provision that the loan agreement between Reid and Depositors Trust contained would grant Depositors Trust an immediate right to demand repayment of the full amount of the outstanding debt even if Reid had not yet received loan funds from Depositors Trust.<sup>138</sup> To avoid recognizing Depositors Trust's unqualified right to demand repayment of Reid's loan at any time, the *Reid* court relied on the use of the term "default" in a separate document as evidence that Depositors Trust could demand repayment only upon Reid's default.<sup>139</sup> Because the court in *Reid* held that the demand provision was not an integrated part of the loan agreement between Reid and Depositors Trust, the court concluded that the note that governed Reid's credit relationship with Depositors Trust was not a demand note.<sup>140</sup> After concluding that Depositors Trust could exercise its right to demand repayment only upon Reid's default, the First Circuit in *Reid* reasoned that the drafters of the U.C.C. did not intend to exclude loan agreements like Reid's from the coverage of section 1-208. The court in *Reid*, therefore, applied section 1-208's obligation of good faith to alter the express terms of the written contract between Reid and Depositors Trust.<sup>141</sup> In applying 1-208 to the loan agreement in *Reid*, the First Circuit focused on a contractual technicality that produced a different result than either Reid or Depositors Trust had intended when they drafted the contract that would govern their loan relationship.<sup>142</sup> Rather than indicating that Depositors

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S.E.2d 916, 918 (Ct. App. 1980) (holding that § 1-208's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand); *Centerre Bank v. Distributors, Inc.*, 705 S.W.2d 42, 48 (Mo. App. 1985) (holding that § 1-203's good faith obligation does not alter lender's contractual right to demand full repayment of borrower's debt that was payable upon demand).

137. See *infra* notes 137-41 and accompanying text (discussing First Circuit's application in *Reid v. Key Bank of S. Maine* of § 1-208's good faith obligation to note containing demand clause); see also *supra* notes 87-93 (discussing First Circuit's reasoning in applying § 1-208's good faith obligation in *Reid*).

138. See *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 13-14 (1st Cir. 1987) (stating that because Reid had not yet received loan funds from Depositors Trust, demand clause note representing line of credit could not be evidence of lender's unqualified right to demand repayment).

139. See *id.* (holding that despite Reid's unqualified execution of demand note, because security agreement securing collateral for loan contained default provisions, Depositors Trust did not retain an unqualified right to demand repayment).

140. See *id.* at 14. (stating that qualified nature of demand clause prevented court from construing loan agreement as demand note).

141. See *supra* notes 136-39 and accompanying text (discussing First Circuit's application of § 1-208's good faith obligation to note containing demand clause in *Reid*); *infra* notes 144-51 and accompanying text (discussing Sixth Circuit's application of § 2-309's good faith notice requirement to limit lender's contractual right to refuse to advance funds against borrower's line of credit in *K.M.C.*).

142. See *Reid v. Key Bank of S. Maine*, 821 F.2d at 14 (reasoning that because of ambiguity in loan documents Depositors Trust was required to comply with obligation of good faith in § 1-208).

Trust would have a qualified right to demand repayment of the outstanding balance on Reid's loan, the language of the demand provision in Reid's loan agreement, like other demand provisions in similar cases, indicated that Depositors Trust would have an unfettered right to call Reid's loan at any time.<sup>143</sup>

In addition to incorrectly altering the terms of express demand notes to apply section 1-208's good faith obligation to require a lender to exercise good faith when the lender calls a demand note, similarly courts incorrectly have applied section 2-309 and section 1-203 to a lender's decision to refuse to advance funds against a borrower's line of credit without prior notice to the borrower of the lender's decision to terminate the line of credit.<sup>144</sup> Contrary to the U.C.C.'s goal of facilitating commerce by allowing parties to set forth in the express terms of a contract the standard of good faith that will govern the contractual relationship, the Sixth Circuit in *K.M.C.* applied the good faith requirement of section 2-309(3) to restrict Irving Trust's express contractual right to terminate the financing agreement between Irving Trust and K.M.C. at Irving Trust's discretion.<sup>145</sup> Section 2-309(3) of the U.C.C. requires that a party to a contract who wishes to terminate the contract give the other party to the contract reasonable notice of the terminating party's decision unilaterally to terminate the contract.<sup>146</sup> In *K.M.C.* the Sixth Circuit stated that section 2-309 imposes upon a lender a good faith obligation to give the borrower notice before the lender refuses to advance funds against a discretionary line of credit.<sup>147</sup> In *K.M.C.*, however, Irving Trust reserved the express contractual right to deny advances against the line of credit at Irving Trust's discretion.<sup>148</sup> Without regard to the U.C.C.'s deference to the express terms of a contract, the Sixth Circuit in *K.M.C.* allowed the good faith obligation of section 2-309(3) to override the express terms of the lending agreement between K.M.C. and Irving Trust.<sup>149</sup> Furthermore, section 2-309(3) typically applies to the termination

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143. *Id.*

144. See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (applying § 2-309's good faith notice requirement to limit lender's contractual right to refuse to advance funds against borrower's line of credit in *K.M.C.*).

145. See *id.* (applying § 2-309's good faith notice requirement to alter Irving Trust's express contractual right to refuse to advance funds against K.M.C.'s line of credit); *supra* notes 13 and 123 and accompanying text (discussing § 1-102(3) of U.C.C. which allows contracting parties to define reasonable standards of good faith to govern contractual relationships).

146. See U.C.C. § 2-309(3) (1987) (requiring that parties who terminate contract give other party to contract prior notice of unilateral termination of contract).

147. See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (applying § 2-309's notice requirement to limit lender's contractual right to refuse to advance funds against borrower's line of credit in *K.M.C.*).

148. See *id.* (holding that Irving Trust breached obligation of good faith to K.M.C. by denying K.M.C.'s request for funds without prior notice to K.M.C. of Irving Trust's termination of K.M.C.'s right to advances against K.M.C. line of credit).

149. See *id.* (applying § 2-309's notice requirement to limit Irving Trust's contractual right to refuse to advance funds against K.M.C.'s line of credit).



of employment contracts, supply contracts, or distributorship contracts.<sup>150</sup> In contrast, most courts have held that Article 2 of the U.C.C. does not apply to nonsales contracts.<sup>151</sup> In *K.M.C.*, however, the Sixth Circuit applied section 2-309(3)'s notice requirement to a lender's refusal to advance funds on a borrower's discretionary line of credit.<sup>152</sup> Because the contract between *K.M.C.* and Irving Trust was a nonsales contract, the Sixth Circuit in *K.M.C.* inappropriately imputed section 2-309(3)'s good faith notice requirement to the lending relationship.<sup>153</sup>

In both *Reid* and *K.M.C.* the First Circuit and the Sixth Circuit arguably interpreted demand notes in a fair manner that protected borrowers from lenders' exercise of the lenders' discretionary rights.<sup>154</sup> Both the *Reid* court and the *K.M.C.* court, however, failed to acknowledge that the borrowers in *Reid* and *K.M.C.* were active participants in the arms-length negotiations that produced the loan agreements.<sup>155</sup> By signing the loan agreements, the borrowers in *K.M.C.* and *Reid* acknowledged and agreed to the conditions that the loan agreements contained.<sup>156</sup> Because each of the loan agreements was the product of free arms-length negotiations between two commercial

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150. See, e.g., *Zidell Explorations, Inc. v. Conval Int'l*, 719 F.2d 1465, 1473 (9th Cir. 1983) (applying § 2-309's notice requirement to party's right to terminate distributorship contract); *Corenswet, Inc. v. Amana Refrigeration, Inc.*, 594 F.2d 129, 137 (5th Cir. 1979), cert. denied, 444 U.S. 938 (1979) (applying § 2-309's notice requirement to party's right to terminate exclusive distributorship contract); *deTreville v. Outboard Marine Corp.*, 439 F.2d 1099, 1100 (4th Cir. 1971) (applying § 2-309's notice requirement to party's right to terminate franchise agreement).

151. See *Van Bibber v. Norris*, 419 N.E.2d 115, 122 (Ind. 1981) (stating that because lender does not satisfy U.C.C. definition of merchant, lender need meet additional obligation of good faith that U.C.C. imposes upon merchants); *Sievert v. First Nat'l Bank*, 358 N.W.2d 409, 414 (Minn. Ct. App. 1984) (stating that commercially reasonable standard of good faith in Article 2 of U.C.C. does not apply to lender's conduct in negotiating refinancing of loan agreement with borrower); *Rigby Corp. v. Boatmen's Bank & Trust Co.* 713 S.W.2d 517, 526 (Mo. Ct. App. 1986) (holding that in relationship between lender and borrower, obligation of good faith is limited to honesty in fact standard of U.C.C.); but see *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (relying on § 2-309 of U.C.C. to alter express contract terms that allowed lender to terminate borrower's line of credit without prior notice to borrower).

152. See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (applying § 2-309's notice requirement to limit lender's contractual right to refuse to advance funds against borrower's line of credit in *K.M.C.*).

153. See *id.* at 759 (holding that § 2-309's good faith notice requirement to limited Irving Trust's contractual right to refuse to advance funds against *K.M.C.*'s line of credit).

154. See *supra* notes 91-93 and accompanying text (discussing First Circuit's interpretation of demand note in *Reid*); *supra* notes 115-116 (discussing Sixth Circuit's interpretation of demand note in *K.M.C.*).

155. See *supra* notes 87-96 and accompanying text (discussing First Circuit's analysis of loan agreement in *Reid*); *supra* notes 110-14 and accompanying text (discussing First Circuit's analysis of loan agreement in *K.M.C.*). *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985). In fact, in *K.M.C.* the court noted that in the absence of the good faith obligation, *K.M.C.* would be entirely at Irving Trust's mercy. *Id.*

156. See *supra* note 154 and accompanying text (discussing courts' analysis of loan negotiation and ultimate loan agreement in *Reid* and *K.M.C.*).

parties, the *K.M.C.* court and the *Reid* court should not have imposed upon the lenders in *K.M.C.* and *Reid* a good faith obligation to shield borrowers from lenders' use of contractual discretionary rights in a manner that the borrower had not contemplated.<sup>157</sup>

Because of the riskiness of lending to small and medium-sized businesses, lenders generally strive to retain as much discretion as possible in the lender-borrower relationship.<sup>158</sup> For example, when contracting with small and medium-sized businesses, a lender often reserves the right to demand full repayment of the loan or refuse to advance funds against the borrower's line of credit at the lender's discretion so that the lender can minimize potential loan losses in the event that the borrower's financial condition deteriorates.<sup>159</sup> Because small and medium-sized business owners realize that the success of their business ventures depends on the business owner's ability to obtain low-cost financing with flexible repayment terms, small and medium-sized business owners willingly grant lenders certain discretionary rights.<sup>160</sup> By including discretionary terms in the loan agreement, the parties allocate the rights under the loan agreement in a manner that satisfies both parties.<sup>161</sup> Discretionary lending, therefore, is an important source of financing for small and medium-sized businesses because by reducing the risks of the transaction to an acceptable level for both parties, discretionary lending encourages lenders to provide the type of flexible financing that small and medium-sized businesses need.<sup>162</sup>

To preserve the viability of discretionary lending in light of recent court decisions like *K.M.C.* and *Reid* that have limited the lender's exercise of discretion, lenders must reevaluate their lending practices to ensure that courts will not apply the U.C.C.'s good faith provisions to alter the express terms of contracts between lenders and borrowers.<sup>162</sup> Specifically, lenders must evaluate loan documents to ensure that these documents clearly, completely, and unequivocally represent the specific terms of the lender-borrower relationship.<sup>164</sup> By drafting loan agreements that contain clear and specific statements of the contracting parties' rights and responsibilities, a

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157. See *supra* notes 153-155 and accompanying text (discussing First Circuit and Sixth Circuit's improper alteration of discretionary lending agreement in *Reid* and *K.M.C.*).

158. See Reisman, *The Challenge of the Proposed Bankruptcy Act to Accounts Receivable and Inventory Financing of Small to Medium-Sized Business*, 83 *Com.L.J.* 169, 211 (1978) (discussing use of discretionary terms in asset-based lending agreements to preserve discretionary lending as viable financing option for lenders to small and medium-sized businesses in light of proposed changes in Bankruptcy Code).

159. *Id.*

160. *Id.*

161. *Id.*

162. See *supra* notes 157-160 and accompanying text (discussing importance of discretionary lending to small and medium sized businesses).

163. See Note, *K.M.C. Co. v. Irving Trust Co.: Discretionary Financing and the Implied Duty of Good Faith*, 81 *Nw. U.L. REV.* 539, 569 (cautioning lenders to enumerate clearly lenders' discretionary rights in loan agreements).

164. *Id.*

lender can demonstrate that the parties specifically have defined a mutually acceptable standard of good faith performance that will govern the parties' actions under the contract.<sup>165</sup> For example, in *Reid* the court focused upon the use of the term "default" in a document related to the loan agreement to qualify the right of a lender holding an unambiguous demand note.<sup>166</sup> To preserve the lender's right to demand repayment of the outstanding loan balance, therefore, the lender in *Reid* should have included provisions in the loan agreement and all related documents that stated unequivocally that the loan was payable on demand at any time and without prior notice to the borrower that the lender intended to call the loan.<sup>167</sup>

By specifically and consistently stating in the loan agreement and related documents that the lender retained an unconditional right to demand repayment, the lender in *Reid* would have removed any ambiguity that the court might have used to construe the demand clause as an acceleration clause.<sup>168</sup> In addition, the clear and unequivocal nature of the demand provision would have served as evidence that the contracting parties clearly agreed to include this term in the loan agreement.<sup>169</sup>

Similarly, by including unequivocal contract terms that will govern the lender's right to refuse to advance funds against a borrower's line of credit, a lender can prevent a borrower from asserting, as the borrower did in *K.M.C.*, that the lender breached an implied duty of good faith.<sup>170</sup> The lender should provide in the loan agreement that in the absence of a valid business reason for withholding notice to the borrower, the lender will give the borrower reasonable prior notice of the lender's decision to terminate the borrower's line of credit.<sup>171</sup> Although the exact length of a reasonable notice period will vary with each type of loan and borrower, the lender should include in each loan agreement a notice period that is objectively

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165. See *id.* (stating that clearly stated loan agreements provide evidence to courts that lender and borrower agreed to specific standards of performance).

166. See *Reid v. Key Bank of S. Maine*, 821 F.2d 9, 13-14 (1st Cir. 1987) (stating that default provision in security agreement qualified Depositors Trust's right to demand repayment from *Reid*); see *supra* notes 91-92 and accompanying text (discussing First Circuit's interpretation of demand note in *Reid*).

167. See *supra* notes 161-63 and accompanying text (discussing necessity for clear language in loan agreements to preserve lender's rights).

168. See *supra* notes 161-64 and accompanying text (discussing methods by which lender can reduce possibility that courts will limit lender's unqualified right to demand repayment).

169. See *supra* note 162 and accompanying text (stating necessity that language of loan agreement clearly establish essence of agreement between parties).

170. See *infra* notes 170-73 and accompanying text (discussing methods by which lender can reduce possibility that courts will construe lender's refusal to advance funds against line of credit without prior notice as breach of good faith obligation).

171. See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 762-63 (6th Cir. 1985) (discussing provision of loan agreement between *K.M.C.* and Irving Trust that allowed Irving Trust to refuse to advance funds to *K.M.C.* against *K.M.C.*'s line of credit without prior notice). In *K.M.C.*, the Sixth Circuit stated that if the financing agreement had provided a period of advance notice even as brief as 48 hours, court would have decided case differently. *Id.* at 763.

reasonable in the particular situation.<sup>172</sup> By including in the loan agreement a short but objectively reasonable period of notice prior to terminating a discretionary line of credit, the lender will discourage courts from imposing a period of notice that conflicts with the express provision of the loan agreement.<sup>173</sup>

In addition to striving to prepare loan documents that clearly reflect the understanding between the parties, a lender also should avoid harsh contractual terms that the lender does not intend to enforce against the borrower.<sup>174</sup> Harsh or threatening contract terms place the lender in an unfavorable light and may convince a judge or a jury that the lender was not contracting in good faith with the borrower.<sup>175</sup> By including temperate and realistic provisions in the contract, the lender does not risk antagonizing a judge or a jury.<sup>176</sup> Finally, lenders periodically should review loan documents with legal counsel to ensure that the provisions of the documents conform with present law.<sup>177</sup>

Although in cases that involve the obligation of good faith courts primarily focus on the terms of the loan agreement, a lender interested in avoiding a borrower's allegations that the lender breached an implied obligation of good faith also must reevaluate the lender's behavior in discretionary loan situations.<sup>178</sup> At all times during a lending relationship, a lender's written and verbal communications with the borrower should be temperate, objective, and businesslike.<sup>179</sup> In addition, lenders should maintain complete borrower files.<sup>180</sup> These borrower files should contain all relevant correspondence including periodic file memoranda.<sup>181</sup> The loan officer that is primarily responsible for the problem loan should prepare

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172. See *infra* note 172 and accompanying text (stating that courts are less likely to impose court's own notice requirement upon lender if loan agreement includes reasonable notice period).

173. See U.C.C. § 1-102(3) (1987) (stating that contracting parties may define reasonable requirements of good faith performance within terms of contract).

174. See Capello, *Banking Malpractice?*, CASE & COM., Sept.-Oct. 1986, at 3, 6-7 (stating that because of recent increase in lender liability cases, lenders must treat borrowers reasonably and fairly).

175. See *id.* (stating that judges and juries may scrutinize fairness and reasonableness of lender's behavior in credit transactions).

176. *Id.*

177. See Moss, *Borrowers Fight Back with Lender Liability*, A.B.A. J., Mar. 1, 1987, at 64, 72 (discussing importance of legal counsel in each step of collection process).

178. See Capello, *supra* note 173, at 6-7 (stating that sound business principles require that lender behave professionally at all times in credit transaction).

179. *Id.*

180. See Moss, *supra* note 176, at 72 (stating importance that lender retain complete documentation of all pertinent conversations and lender's plan of action in preparing successful lender's defense against borrowers' claims in lender liability actions); *but see* Swartz, *Lender Liability*, U.S. BANKER, May 1986, at 10, 22 (stating that lender's tendency to keep extensive borrower files is harmful to lender because borrower may subpoena lender's files and use this information against lender).

181. See Moss, *supra* note 176, at 72 (discussing importance of documenting pertinent developments in lender-borrower relationship).

file memoranda that honestly and objectively assess the borrower's present status, summarize related conversations with the borrower, and outline the lender's proposal to address the situation.<sup>182</sup>

To prevent personal bias, committees should review an individual loan officer's decision to call a loan or terminate a line of credit.<sup>183</sup> Before implementing any enforcement action against a borrower, the lender should review the borrower's file and audit all pertinent loan documents.<sup>184</sup> If the lender discovers any irregularities during the lender's review of the borrower's file and loan documentation, the lender should confer with legal counsel before instituting any collection action against the borrower.<sup>185</sup> If possible, the lender also should provide the borrower reasonable notice of the impending enforcement action.<sup>186</sup>

Throughout the collection process, the lender should be sensitive to the borrower's interests and concerns.<sup>187</sup> Above all, the lender must remember that a judge or jury later may scrutinize the lender's behavior during the collection process.<sup>188</sup> The lender, therefore, must make every effort to foster fair dealing when exercising discretion in the collection process.<sup>189</sup>

The U.C.C. requires lenders, like all parties to commercial contracts, to perform contractual obligations in good faith.<sup>190</sup> Although the U.C.C. prohibits contracting parties from totally disclaiming good faith obligations in contracts, in deference to the express terms of the parties' written agreement, the U.C.C. allows parties to define a reasonable standard of good faith that will govern the relationship between the contracting parties.<sup>191</sup> Despite the U.C.C.'s deference to reasonable standards of good faith

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182. See *supra* notes 179-80 (discussing importance of lender's objective documentation of developments in lender-borrower relationship).

183. See Swartz, *supra* note 179, at 22 (stating importance that lender not grant individual loan officers sole authority to call loan or terminate line of credit). In *K.M.C.* the jury considered evidence that Irving Trust's loan officer may have based his decision to terminate *K.M.C.*'s line of credit upon personality conflict. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 761 (6th Cir. 1985).

184. See Swartz, *supra* note 179, at 22 (stating that sound business practices require that lender be fully apprised of both borrower's and lender's status in light of borrower's changed financial position).

185. See Moss, *supra* note 176, at 72 (discussing importance of legal counsel in each step of loan collection process).

186. See *supra* notes 177-78 and accompanying text (stating that sound business principles require that lenders treat borrowers fairly and reasonably).

187. See *supra* notes 177-78 and accompanying text (stating that lenders must be reasonable and fair in dealing with borrowers).

188. See *supra* notes 174-75 and accompanying text (stating that judges and juries may scrutinize fairness and reasonableness of lender's behavior in credit transactions).

189. See *supra* notes 161-87 and accompanying text (stating that lenders should adhere to standards of fair dealing to prevent borrowers from alleging that lender breached obligation of good faith and fair dealing).

190. See *supra* notes 11-15 and accompanying text (discussing good faith requirement that U.C.C. implies in every contract that U.C.C. governs).

191. See *supra* note 12-14 and accompanying text (discussing U.C.C.'s deference to contract terms establishing reasonable standards of good faith).

performance that contracting parties set forth in written agreements, the courts in *Reid* and *K.M.C.* applied the U.C.C.'s good faith obligation to alter the reasonable discretionary rights that the loan agreement granted to the lenders in *Reid* and *K.M.C.*<sup>192</sup> In light of the decisions in *Reid* and *K.M.C.*, lenders must take steps to ensure that courts will not impose the obligation of good faith to alter the express terms of loan agreements.<sup>193</sup> By preparing loan agreements that clearly reflect intentions of the parties and by behaving in a businesslike manner, lenders can reduce the possibility that courts will employ the U.C.C.'s obligation to rewrite the express terms of the loan agreement that governs the relationship between a lender and a borrower.<sup>194</sup>

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192. See *supra* notes 87-93 and accompanying text (discussing First Circuit's application of U.C.C.'s good faith obligation to alter lender's express contractual right to demand full repayment in *Reid*); *supra* notes 110-14 and accompanying text (discussing Sixth Circuit's applications of U.C.C.'s good faith obligation to alter lender's express contractual right to refuse to advance funds to borrower without prior notice in *K.M.C.*).

193. See *supra* notes 161-88 and accompanying text (discussing measures that lender can employ to reduce possibility that courts will impose good faith obligation to alter express contract terms).

194. See *supra* notes 161-76 and accompanying text (stating that lender's use of fair and unequivocal contract provisions may prevent courts from altering contracts between lenders and borrowers).