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LENDER LIABILITY TO DEBTORS:
TOWARD A CONCEPTUAL FRAMEWORK

by
Werner F. Ebke* and James R. Griffin**

To pull one misshapen stone out of the grotesque structure is more likely simply to upset its present balance between adverse interests than to establish a rational edifice.¹

RECENT years have witnessed a rapid increase in problem loans. In response, banks² and other commercial lending institutions³ in the United States have used a number of workout practices⁴ to improve or secure their position vis-à-vis their debtors. Such practices, however, have come under increasing attack by debtors, shareholders, creditors, bankruptcy trustees, and others. In the recent Texas case State National Bank v. Farah Manufacturing Co.,⁵ the plaintiff-debtor received a jury award of approximately $19 million in compensatory damages against a group of financial institutions as a result of an alleged conspiratorial course of tortious

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². A bank is commonly defined as an institution that takes deposits and makes commercial loans. See, e.g., Bank Holding Company Act of 1956, 12 U.S.C. § 1841(c) (1982). This definition allows nonbanks to operate as long as they offer only one, not both, of these services. The broad construction of the statute has permitted money market funds and nonbank giants, such as American Express, Merrill Lynch Pierce Fenner & Smith Inc., and Sears Roebuck and Co. to offer various financial services and to establish multistate banking units. For a general discussion of the evolving definition of the term “bank” under the Bank Holding Company Act see Felsenfeld, Nonbank Banks—An Issue in Need of a Policy, 41 Bus. Law. 99, 108-11 (1985). As to the distinction between commercial banking and investment banking see Securities Indus. Ass’n v. Board of Governors, 104 S. Ct. 2979, 2984-86, 82 L. Ed. 2d 107, 114-16 (1984).
⁵. 678 S.W.2d 661 (Tex. App.—El Paso 1984, writ dism’d by agr.).
conduct marked with fraud, duress, and interference with the debtor's corporate governance process. In another recent case a federal court awarded $7.5 million for breach of the implied covenant of good faith and fair dealing resulting from a lender's refusal to advance funds up to the credit limit under a preexisting financing agreement. Lenders may also be subject to substantial punitive damages as a result of their conduct in relation to their debtors. In one recent California case the court affirmed a $1 million jury verdict against a lender who fraudulently represented that it would advance additional funds to its debtor. In view of these recent decisions it is no wonder that the developing theories of lender liability have inspired fear and mystery in bankers, borrowers, and lawyers.

The theories of liability that have been asserted against commercial lenders in the United States include both common law and statutory claims. The common law claims usually are based upon tort principles such as fraud, breach of fiduciary duty, breach of the implied covenant of good faith and fair dealing, duress, and interference. Statutory claims have been asserted under the Uniform Commercial Code, the Bankruptcy Code, the federal securities laws, the tax and wage laws, and the Racketeer Influenced and Corrupt Organizations Act (RICO).

Rather than plunging into the technical and doctrinal details of the emerging theories of liability that have been asserted against commercial lenders in the United States, this Article analyzes the present and possible future concepts of distribution of risks in commercial lending transactions. The primary objective of this Article is to develop a model that can be implemented to draw a balance between the competing interests of lenders and debtors. The discussion first focuses upon the impact of common law theories on lender liability resulting from alleged misconduct. The Article then focuses upon the legal, economical, and social expediency of the emerging theories.
theories of lender liability and discusses possible alternatives to contemporary solutions.

I. THE FARAH CONTROVERSY: AN UNCOMMON EXPERIENCE

State National Bank v. Farah Manufacturing Co.\textsuperscript{15} vividly illustrates the legal and economic risks as well as the practical problems associated with a lender’s attempt to improve its position vis-à-vis the debtor. The case centers around a management change clause contained in a $22 million loan agreement. In order to appreciate fully the significance of this case and the holdings of the Texas Court of Appeals in El Paso, a close look at the facts of the case and the events giving rise to the litigation is not only helpful, but necessary.

A. Success, Failure, and Change

Farah Manufacturing Company (FMC) began operations in 1919 as a family-owned apparel manufacturer. In 1976 FMC was a company besieged with problems. The El Paso, Texas, corporation was burdened by low sales, high production costs, excess plant capacity, and unsold inventory. The company was recovering from a bitter, drawn-out labor strike that was accompanied by a nationwide boycott of its products.\textsuperscript{16} In addition to the labor unrest, discontent existed throughout the executive offices of FMC during that troubled period. A number of upper-management employees left FMC. During the period from 1972 to July 1976 the company experienced a pre-tax loss of more than $43 million, and shareholder’s equity declined by $24.9 million.

Since 1964 William F. Farah had served as chairman of the board of directors, chief executive officer, and president of FMC. Farah was a blunt, self-confident man who relied upon his own instincts rather than upon sophisticated marketing and management techniques. Although FMC was a publicly held company listed on the New York Stock Exchange, the Farah family dominated and controlled the affairs of the company. Under Farah’s leadership, FMC grew from a small domestic apparel manufacturer into a major international business enterprise.

The problems of the 1970s, however, threatened the existence of the company. In early 1976 the Board of Directors of FMC (the Board), a board hand-selected by Farah, concluded that FMC had outgrown Farah’s ability and that new leadership was necessary. The Board elected William Leone to the office of president and chief operating officer of FMC, and in July of 1976 Leone replaced Farah as chief executive officer.\textsuperscript{17} Although Farah

\begin{itemize}
  \item \textsuperscript{15} 678 S.W.2d 661 (Tex. App.—El Paso 1984, writ dism’d by agr.).
  \item \textsuperscript{16} The strike began in 1972 and was not settled until 1974.
  \item \textsuperscript{17} Farah criticized and undermined Leone’s business plan from the beginning of Leone’s presidency. Noting Farah’s persistent, unwarranted interference, the Board forced Farah to resign as chief executive officer in July 1976. The Board expressed displeasure with Farah’s management style, which was characterized by insubordination to Board directives and inadequate disclosure to the Board.
\end{itemize}
continued to serve as chairman of the Board, Leone possessed exclusive responsibility over the affairs of the company. As a director of FMC since 1973, Leone was familiar with the affairs and problems of the company. Leone implemented a conservative plan to streamline operations and reposition the company as a smaller producer of basic products. He also began negotiations for a working capital loan to replace funds lost during the strike and through unprofitable operations. Neither the business plan nor the loan negotiations proved immediately successful. Several major banks announced that they would not participate in a loan package to FMC. The company's primary lender for over thirty years not only refused to participate in a working capital loan, but also terminated its line of credit with the company.\textsuperscript{18}

\textbf{B. The Loan Agreement}

Not until June 1976 did three banks, Continental Illinois National Bank and Trust Company of Chicago (Continental), Republic National Bank of Dallas (Republic),\textsuperscript{19} and State National Bank of El Paso (State National), agree to enter into an $18 million interim financing arrangement with the company. The banks relied upon Leone's ability to stop losses and improve sales as well as upon his proposal to terminate and dispose of unnecessary operations. On October 18, 1976, the interim financing agreement was converted into a permanent revolving line of credit. The permanent loan agreement provided for an unsecured, four-year loan in the amount of $22 million. To minimize the risks inherent in a long-term loan to FMC the lenders included a management change clause in the permanent loan agreement.\textsuperscript{20} The clause permitted the lenders to call the loan if the prospect of repayment was jeopardized by the removal of Leone as chief executive officer of FMC.

FMC continued to falter. By the end of 1976 the company had breached four financial covenants in the loan agreement.\textsuperscript{21} Citing continued confidence in Leone, the lenders waived the default in each instance. After additional defaults of financial covenants in the loan agreement the banks, in conjunction with the Prudential Insurance Company of America (Prudential),\textsuperscript{22} restructured the loan agreement. Under the new agreement, dated February 14, 1977, the lenders obtained a first lien security interest in FMC's equipment, real estate, and machinery.\textsuperscript{23} The agreement also contained relaxed financial covenants and a strengthened management change change

\textsuperscript{18} Brief of Appellant at 22 (copy on file at offices of \textit{Southwestern Law Journal}).

\textsuperscript{19} Now RepublicBank Dallas, N.A.

\textsuperscript{20} The lenders were aware of the risks associated with a long-term loan to FMC. In a memorandum prepared in August 1976 the lenders expressed confidence in Leone's ability to turn the company around. The memorandum, however, also noted that the banks would face a serious workout situation if Leone failed. Brief of Appellee at 18-19 (copy on file at offices of \textit{Southwestern Law Journal}).

\textsuperscript{21} Brief of Appellant at 29.

\textsuperscript{22} Prudential was a creditor of FMC under a 1971 loan agreement.

\textsuperscript{23} FMC asserted that the value of the collateral was approximately $72 million, more than three times the amount of the loan itself. FMC therefore argued that "[o]nce the loan
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clause that allowed the lenders to declare a default if any change in FMC's executive management occurred that was contrary to the lenders' interests.24

C. The Battle for Control Begins

Despite the efforts of Leone, FMC sustained substantial additional losses. Fearful that the company was destined for bankruptcy, Farah requested the Board to dismiss Leone and elect him as chief executive officer. At its meeting on March 7, 1977, the Board declined to consider the request. The Board expressed concern that Farah's election might trigger a default in the restructured loan agreement. The Board instructed Farah to present his plan to a meeting of the lenders.25

At the meeting with the lenders on March 14, 1977, Farah described FMC's problems, presented his management plan, and proposed a method to pay off the loan. Farah's proposal included the liquidation of excess inventory and the disposition of certain assets. Although State National expressed opposition to the proposal, the question of Farah's return was left unresolved. The lenders did, however, advise Farah that a change in the chief executive office of FMC could violate the management change clause. On the following day John Bunten, a senior loan officer and vice president of Republic, assigned the FMC loan to a Republic workout specialist.

On March 16, 1977, Farah and Bunten coincidentally boarded the same flight from Dallas to New York. During the flight Bunten indicated that the management change clause was mere boilerplate and that Farah should return to El Paso and resume control. Thereafter, Farah began careful planning and preparation for his return to management and for the future of FMC.

On March 17, 1977, Leone tendered his resignation from the Board. He felt that Farah's persistent demands to become chief executive officer had caused irreparable harm to the company. At the Board meeting held on March 18, 1977, Farah nominated three candidates to fill board vacancies. The election of Farah's candidates would have assured his own election. Only one candidate, Richard Azar, however, agreed to serve.26 Following Azar's election, William Conroy, an employee and director of FMC since the late 1950s and also a State National director, announced his candidacy.
for chief executive officer in opposition to Farah. Because a quorum of the Board was not available, the Board took no action toward the election of a chief executive officer. Instead, the Board authorized director Gordon Foster to request the banks to state their position under the management change clause.

D. The Lenders' Position

On March 21, 1977, the lenders met to consider their response under the management change clause to Farah's candidacy. The representatives of Continental and State National opposed Farah's return. The banks then had two options: they could either waive the default and acquiesce in Farah's election, or they could declare the default and almost certainly force FMC into bankruptcy. State National did not want the responsibility for the bankruptcy of the largest private employer in El Paso, Texas, nor was State National willing to accept Farah's return.

Since neither option under the management change clause was acceptable, the lenders created a third option to prevent Farah's election. The lenders advised the Board that the election of Farah as chief executive officer was unacceptable and that the banks would not grant a waiver of default if Farah was elected. The lenders agreed, however, to consider a waiver if the Board concluded that a change in the chief executive office, involving others than Farah, would be in the best interests of FMC. Although the lenders had not made a corporate decision to call the loan, their statement could have created the false impression that a condition of default would be enforced if Farah were elected.

On March 22, 1977, the Board reconvened to consider the lenders' response. Director Gordon Foster warned the Board that the banks would call the loan if Farah were elected. Farah, relying upon his conversation with Bunten less than a week earlier, remained undeterred in his effort to regain control of FMC. He nominated two new candidates to the Board who would support his bid for control. No action was taken on the election of either Farah or his candidates. After the meeting Foster informed the lenders of Farah's plans and of Leone's pending resignation as chief executive officer.

Early on March 23, 1977, the lenders met to reevaluate their position.

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27. The representative of Continental felt that "if Farah were elected he should be strongly controlled and have life made miserable for him." 678 S.W.2d at 671.

28. Due to cross-default provisions in FMC's bond indentures, the company would face an immediate cash demand of approximately $40 million. Brief of Appellee at 42. If FMC became bankrupt the lenders would lose their secured position under the February 14, 1977, agreement. See infra note 43. Presumably, the lenders' desire to avoid or delay the bankruptcy of FMC affected their choice of tactics.

29. The text of the lenders' letter is reproduced in full in the FMC brief. Brief of Appellee at 47-49.

30. Following the meeting of the lenders on March 21, 1977, Continental's representative noted that "[t]here was no decision" to call the loan if Farah were elected chief executive officer. 678 S.W.2d at 671.

31. Id. at 672.
Unless the lenders acted expeditiously and decisively, Farah's election was virtually certain. Director Richard Azar, who was largely unfamiliar with the problems and affairs of FMC, was regarded as the swing vote on the Board. Later the same day the lenders met with Azar to explain the implications of the management change clause. Azar informed Jim Donohoe, attorney for Republic, that only Farah could turn FMC around. In response, Donohoe stated that he would automatically bankrupt the company and padlock the doors if Farah were elected president of the company. A further verbal exchange with Donohoe convinced Azar that the lenders' threats were real. Azar not only agreed to vote for Conroy, but also agreed to urge Farah to abandon his candidacy.

Immediately prior to the Board meeting scheduled later the same day, Mr. Donohoe pounded the table in front of Farah and reiterated that he would bankrupt the company and padlock the doors if Farah did not withdraw his candidacy for chief executive officer and resign as chairman of the Board. Azar met with Farah and confirmed Donohoe's threats. Farah was shocked and stunned. In a state of dismay he followed the lenders' dictates and nominated Conroy as chief executive officer and Foster as chairman of the Board. Conroy and Foster were unanimously elected, and the lenders agreed not to deem Conroy's election an event of default. Although the management change clause did not extend to the election of directors, the Board, under pressure from the lenders, refused to consider the election of the candidates for the Board nominated by Farah.

E. A Management Satisfactory to the Lenders

On April 4, 1977, Judson Williams, Ray Pulley, and Robert Jaynes were nominated and elected to FMC's board of directors. Williams was also a member of the board of directors of State National. Pulley, a former employee of Republic, was initially responsible for Republic's participation in the FMC loan. As a condition to accepting the nomination Pulley required Republic to execute an indemnification agreement in his favor. Jaynes was the only new director with no apparent conflict of interest.

Under Conroy's leadership FMC's financial condition continued to decline. Upon the lenders' recommendation the Board retained the services of Grisanti and Galef, a nationally renowned consulting firm and workout specialist. Initially, Andrew Galef's activities included only monitoring FMC's operations; however, Galef undertook greater responsibilities as Conroy's inability to turn FMC around became obvious. In July 1977 Conroy resigned as chief executive officer, and the Board elected Galef to the position. Under Galef's leadership expenses soared while revenues declined. Galef was unable to turn FMC around due to his inexperience in the men's apparel business. In order to make prepayments on the loan to FMC, Galef em-

32. Following the election of Williams and Jaynes, Jimmy Farah resigned as a director to create a vacancy on the Board for Pulley.
33. On September 24, 1977, Conroy resigned from the Board.
barked on a plan of gradual liquidation of FMC. Galef, like Conroy and Leone, was unable to restore financial stability to FMC.

F. Farah’s Return

In response to a Board resolution calling for Farah’s resignation as a director, both Azar and Farah resigned from the Board. Shortly thereafter, Farah began a proxy contest to regain control of FMC. Farah felt that he had to act quickly to prevent FMC’s bankruptcy. The lenders’ threats to bankrupt the company no longer intimidated Farah. As the trustee of a voting trust created by his brother, Farah controlled approximately forty-six percent of FMC voting stock. Litigation supported by the lenders to remove Farah as trustee proved unsuccessful, and Farah’s success in the proxy fight was assured.

Farah regained control of FMC in April of 1978. Since then, FMC has grown and prospered. Farah reestablished FMC as an able competitor in the men’s apparel market; he transformed losses into profits and near-bankruptcy into prosperity. Despite the coordinated opposition of the lenders, he succeeded where others had failed in turning around FMC. Under Farah’s leadership FMC refinanced the loan and ultimately repaid the loan in full.

In 1981 FMC filed suit against the lenders for damages incurred during the period from April 1977 through March 1978. At the end of a lengthy trial the jury returned a verdict in favor of FMC. The jury found that during the period in question the lenders committed acts of fraud, duress, and interference that proximately resulted in $18,947,348.77 of damages to the company. The components of the damages award were as follows: $2,668,000.00 in actual losses during the period from April 1977 through March 1978; $15,482,500.00 in lost profits during the period in question; $721,848.77 attributable to auction sale losses; and $75,000.00 in lost profits from auction sales. On appeal the damage award was modified and affirmed. Although the Texas Supreme Court granted a writ of error, the case was subsequently dismissed by agreement of the parties.

II. THE COMMON LAW THEORIES OF LENDER LIABILITY

The decision of the appellate court in Farah rested on the unique application of three well-established common law theories: fraud, duress, and interference. Prior to Farah no court in the United States had applied those theories jointly in the context of a debtor-creditor relationship. The unique-

34. For a review of the legal and practical issues connected with proxy contests see: E. ARANOW & H. EINHORN, PROXY CONTESTS FOR CORPORATE CONTROL (2d ed. 1968); Emerson & Latcham, Proxy Contests: A Study in Shareholder Sovereignty, 41 CALIF. L. REV. 393 (1953).
35. For a succinct review of the legal and practical issues connected with voting trusts see H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 528-34 (3d ed. 1983).
37. 678 S.W.2d at 667.
38. The El Paso court of appeals granted a remittitur of $300,105.00. Id. at 699.
ness of the *Farah* decision does not mean, however, that other common law claims against lenders have not been made. Courts throughout the United States have held lenders liable under various complex theories of control,39 and recently some state courts have held lenders liable for breach of the implied covenant of good faith and fair dealing.40 Additionally, one state court has considered the applicability of the prima facie tort theory in a lender liability case.41

Although this Article limits its presentation to the common law theories of lender liability, possible statutory bases of liability also exist. Claims against lenders may be asserted under the Uniform Commercial Code (UCC),42 the Bankruptcy Code,43 the federal securities laws,44 the tax and

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40. "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Restatement (Second) of Contracts § 205 (1979). See generally Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith,* 94 Harv. L. Rev. 369, 378-94 (1980) (discussing operational standard for good faith performance of contracts). Liability under the implied covenant of good faith and fair dealing may be based upon statutory law as well as the common law. For a detailed discussion of the implied covenant of good faith and fair dealing and cases relying upon the implied covenant, see infra notes 121-42 and accompanying text.


42. See U.C.C. §§ 1-201(19), 1-203, 1-208, 2-309 (1977). Id. § 1-203 states that: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." The UCC defines "good faith" as "honesty in fact in the conduct or transaction concerned." Id. § 1-201(19). Id. § 1-208 states:

A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

Although art. 2 of the UCC is applicable only to contracts for the sale of goods, id. § 2-102, one court recently relied on id. § 2-309 in holding a lender liable for failure to notify its borrower prior to a refusal to lend. K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 759-60 (6th Cir. 1985). For a detailed discussion of this case see infra notes 124-30 and accompanying text. U.C.C. § 2-309(3) (1977) states: "Termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable."

43. 11 U.S.C. § 510(c) (1982) provides that "under principles of equitable subordination, [a court may] subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim." Under § 547(b) of the Bankruptcy Code, a creditor may also be required to return property received in a preferential transfer. 11 U.S.C. § 547(b) (1982); see Pepper v. Litton, 308 U.S. 295, 308 (1939) ("bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administra-


Every person who, by or through stock ownership, agency, or otherwise, or who, pursuant to or in connection with an agreement or understanding with one
wage laws, and RICO. This Article leaves discussion of these sources of lender liability to other authors.

The following section of the Article explores the specific facts and legal theories that led to liability in Farah. In contrast to the Farah theories this section also discusses the pervasive requirements of control under instrumentality and agency theories. Finally, this section introduces briefly the theories of good faith and fair dealing and prima facie tort.

A. The Farah Theories

FMC based its claims against the lenders upon the theories of fraud, duress, and interference. Although FMC argued each theory independently, the court's opinion suggests that a great deal of similarity exists between these common law tort claims. Indeed, the Restatement (Second) of Torts

or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under sections 77k or 77l of this title, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

15 U.S.C. § 77o (1982). Section 20(a) of the 1934 Act provides:

Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

Id. § 78t(a). For a discussion of a controlling person's liability under the 1933 and 1934 Acts see T. Hazen, The Law of Securities Regulation 207-08, 284 (1985); L. Loss, Fundamentals of Securities Regulation 441-56 (1983). Although the federal securities laws contain no statutory definition of control, the Securities and Exchange Commission has defined control as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405 (1985).

45. A lender who finances the payroll of its debtor may be liable under the Internal Revenue Code for failure to collect and remit wage withholding taxes. I.R.C. § 3505(a) (1982) provides:

If a lender . . . who is not an employer . . . pays wages directly to such an employee or group of employees . . . such lender . . . shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

A similar liability provision applies in situations in which the lender supplies money to the debtor for wages to be paid by the debtor. Id. § 3505(b).

46. A lender may be liable for engaging in activities prohibited under the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (1982). Id. § 1962(a) provides:

It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal . . . to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

Section 1963 may subject a lender to criminal liability for RICO violations and § 1964 may subject a lender to civil liability. Id. §§ 1963, 1964.
suggestions that fraud and duress may constitute acts of interference.47

1. Fraud.

FMC's cause of action for fraud focused upon the lenders' "no waiver" letter of March 22, 1977, to the Board.48 The action further focused upon the statements made by Republic's attorney Donohoe to Farah and other members of FMC's Board on March 23, 1977, regarding the bankruptcy and padlocking of FMC if Farah were elected as chief executive officer.

A well-established common law principle exists that a person who fraudulently makes a misrepresentation of fact for the purpose of inducing another person to act is liable for injuries caused to the relying person.49 In addition, a representation capable of two interpretations, one known to be false and the other known to be true, may also constitute a fraudulent statement.50 Stirling v. Chemical Bank51 illustrates this tort doctrine as applied to bankers' liability cases. In this case the plaintiffs alleged that they resigned their positions as officers and directors of the debtor company in reliance upon the lenders' false representations that they would make further loans and not call outstanding loans of the company. The court held that fraud would support a cause of action against the lenders who were attempting to manipulate the management of the debtor company.52

In another recent case in California a jury awarded a debtor $1 million in punitive damages against a lender as a result of the lender's fraudulent representations to the debtor. In Sanchez-Corea v. Bank of America53 the debtor critically needed additional funds. The lender represented that it would advance further financing in return for an assignment of all the debtor's accounts receivable. At that time, however, the lender had determined not to advance additional funds. Following the accounts receivable assignment, the lender turned down the debtor's long-term loan application. At trial the jury awarded the debtor $1 million in punitive damages, and the California Supreme Court subsequently affirmed the decision.54

In a similar sense, the lenders in Farah manipulated the management of

47. See Restatement (Second) of Torts § 767 comment c (1977).
48. See supra notes 29-31 and accompanying text.
49. Restatement (Second) of Torts § 525 (1977) states:
   One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.
50. Id. § 527 states:
   A representation that the maker knows to be capable of two interpretations, one of which he knows to be false and the other true is fraudulent if it is made:
   (a) with the intention that it be understood in the sense in which it is false, or
   (b) without any belief or expectation as to how it will be understood, or
   (c) with reckless indifference as to how it will be understood.
52. Id. at 1153.
54. Id. at 898, 910, 701 P.2d at 830, 839, 215 Cal. Rptr. at 683, 692.
FMC through a fraudulent course of conduct. The court found that the lenders' statement that they would not grant a waiver of default if Farah were elected chief executive officer was a misrepresentation of the lenders' actual intentions. According to the court the lenders intended the statement to create the impression that they would declare and enforce a default in the loan agreement upon Farah's election. Donohoe, attorney for Republic, perpetuated the fraud in his conversations with Azar and Farah when he threatened to bankrupt and padlock the company. The lenders contended, on the other hand, that their written and oral statements under the management change clause amounted to no more than the ordinary hard bargaining characteristic of negotiations in the lending industry. The court disagreed with the lenders and stated that the representations of the lenders amounted "to more than a mere opinion, judgment, probability or expectation on the part of the lenders."  

2. Duress.

FMC's cause of action for duress, like its fraud claim, focused upon the lenders' letter of March 22, 1977, and upon the statements made by Republic's attorney Donohoe to Farah and other Board members on March 23, 1977, concerning the bankruptcy and padlocking of FMC. Additionally, FMC based its duress claim upon the prevention of the election of Farah's candidates for the Board. As a matter of law duress occurs when one person unlawfully threatens another person, thereby causing that person to do that which he otherwise would not do. The existence of alternatives, i.e., bow to the threat of duress or accept bankruptcy, does not preclude the possibility of duress. Also referred to as business compulsion or economic coercion, duress does not exist unless the threatened harm is imminent and no present means of protection are available. A claim of duress must, how-

55. 678 S.W.2d at 682.
56. Id.
57. Id. at 681-82.
58. The lenders' brief on appeal provides examples of legitimate acts in a bargaining context that are misleading but not fraudulent including: a union's threat of strike intended to effect higher wages; a landowner's posting of a sign stating "trespassers will be prosecuted;" a lawyer's writing of a demand letter knowing that his client has not yet decided whether to sue. Brief of Appellant at 91. The court apparently rejected these examples as mere statements of opinion or expectation. 678 S.W.2d at 681-82.
59. 678 S.W.2d at 681-82.
61. Id. § 1617.
62. See Continental Ill. Nat'l Bank & Trust Co. v. Stanley, 606 F. Supp. 558 (N.D. Ill. 1985). In Stanley the court distinguished between a threat of imminent harm and mere hard bargaining. Id. at 562. Stanley alleged that, in light of the threat of imminent bankruptcy and a cutoff of credit, he was forced to execute a personal guaranty in favor of the lenders to back up an extension of credit to his company. The court rejected Stanley's assertion, stating that "[d]uress does not exist merely where consent to an agreement is secured because of hard bargaining positions or the pressure of financial circumstances." Id. The court concluded that the lender's threat was not wrongful and that the threatened harm was not imminent. Id. The court therefore held that no genuine issue of material fact existed to support Stanley's claim of duress. Id.
ever, be based upon the conduct of the threatening party and not on the preexisting vulnerability of the threatened party. Furthermore, the mere exercise or threatened exercise of a valid legal right cannot form the basis of a claim of economic coercion.

In *Spillers v. Five Points Guaranty Bank* the court stated that duress may exist if a party threatens to enforce legal rights that in fact are nonexistent. The debtors in *Spillers* sought to prevent the foreclosure of certain liens on their personal and real property. The debtors claimed that the lenders coerced them into signing the various security documents at the time of the execution of a renewal note. The court found that the debtors were coerced only in the sense that they could either agree or refuse to sign the documents. The natural consequence of refusal, however, was default and acceleration of the debt, thereby resulting in the bankruptcy of the business. Nevertheless, the court held that the lenders had a legal right to require the execution of the security agreement; therefore, actionable duress did not exist.

Arguably, the lenders in *Farah*, like the lenders in *Spillers*, acted pursuant to a valid legal right, the right conferred by the management change clause to declare a default and accelerate payment upon a change in the office of chief executive officer of FMC. The *Farah* court concluded, however, that actionable duress may exist when one enforces or threatens to enforce legal rights in bad faith. The court found that the lenders acted in bad faith by threatening to declare a default and accelerate payment of the loan at a time when FMC was not in default and no impaired prospect for repayment existed. The *Farah* court stated that “[e]ven where an insecurity clause is drafted in the broadest possible terms, the primary question is whether the creditor’s attempt to accelerate stemmed from a reasonable, good-faith belief that its security was about to become impaired.” The court noted that

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63. First Tex. Sav. Ass’n v. Dicker Center, Inc., 631 S.W.2d 179, 186 (Tex. App.—Tyler 1982, no writ) (“[s]tress of business conditions will not constitute duress unless the defendant was responsible for that condition”).
64. Sanders v. Republic Nat’l Bank, 389 S.W.2d 551, 554 (Tex. Civ. App.—Tyler 1965, no writ) (no duress when bank lawfully refused to close sale prior to payment of past due rent); see also 25 AM. JUR. 2D Duress and Undue Influence § 18 (1966) (threatening to exercise legal right not duress).
66. Id. at 852.
67. Id. at 852-53.
68. Id. at 853.
69. See supra note 24.
70. 678 S.W.2d at 684.
71. Id. at 685-86. The court, analogizing the management change clause to an insecurity clause, cited the good faith acceleration requirement in § 1-208 of the Uniform Commercial Code. For the text of § 1-208 see supra note 42. See also Brown v. Avemco Inv. Corp., 603 F.2d 1367, 1378-80 (9th Cir. 1979) (U.C.C. § 1-208 applies to “default acceleration clauses” as well as “insecurity acceleration clauses”).
72. 678 S.W.2d at 685. The *Farah* court seems to have relied on the implied duty of good faith and fair dealing. In English v. Fischer, 660 S.W.2d 521 (Tex. 1983), however, the Texas Supreme Court rejected the implied duty of good faith and fair dealing as a basis for action in contract under Texas law. Id. at 522. The court stated: “The novel concept [of good faith and fair dealing] would abolish our system of government according to settled rules of law and let
Farah's election could have constituted a default enabling the lenders to enforce their legal rights at the time.\textsuperscript{73} Instead, the lenders resorted to pre-election threats and warnings designed to prevent the election of Farah. The \textit{Farah} court concluded that the duress did not result from FMC's preexisting financial condition; rather, the duress turned on the threats of default, imminent bankruptcy, and padlocking.\textsuperscript{74}

\section{Interference.}

FMC based its interference claim upon the lenders' conduct that led to the reversal of Azar's vote and the rejection of Farah as a candidate for chief executive officer of FMC. The lenders further interfered with FMC's lawful corporate governance process by installing Conroy as chief executive officer, forcing Farah's resignation as chairman of the Board, and thereafter substituting Foster as chairman. Additionally, the lenders packed the Board with their own hand-picked representatives and installed Galef as consultant and subsequently as chief executive officer. Furthermore, the lenders supported the proxy fight against Farah as he lawfully attempted to regain control of FMC.

An actionable claim for interference exists when one party intentionally and improperly interferes with the performance of a contract by causing one of the contracting parties not to perform under the contract.\textsuperscript{75} Under the common law theory of interference a lender could only be held liable for specific acts of interference with specific contracts or prospective contractual relations.\textsuperscript{76} Although some courts have held that the theory of interference will protect ordinary business relations,\textsuperscript{77} the \textit{Farah} court expanded the theory of interference beyond mere business relations to afford legal protection to the corporate governance rights of debtor corporations and their shareholders.\textsuperscript{78} Under \textit{Farah}'s unprecedented expansion of the interference theory the establishment of a specific contract or prospective contractual

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\textsuperscript{73} 678 S.W.2d at 686.
\textsuperscript{74}  Id. at 687.
\textsuperscript{75} \textit{Restatement (Second) of Torts} § 766 (1977):
One who intentionally and improperly interferes with the performance of a contract ... between another and a third person by inducing or otherwise causing the third person not to perform the contract, is subject to liability to the other for the pecuniary loss resulting to the other from the failure of the third person to perform the contract.
In a common law action based on interference a plaintiff need not show that the interfering party acted with an intent to harm. A plaintiff must only show that the acts were willful and intentional. 678 S.W.2d at 690.
\textsuperscript{76} See \textit{Restatement (Second) of Torts} §§ 766, 766A, 766B (1977).
\textsuperscript{77} See \textit{Melamed v. Lake County Nat'l Bank}, 727 F.2d 1399, 1404 (6th Cir. 1984). For a detailed discussion of \textit{Melamed} see \textit{infra} notes 81-84 and accompanying text.
\textsuperscript{78} 678 S.W.2d at 690.
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relationship does not seem to be essential to an actionable claim for interference in a debtor's corporate governance. The court found that the lenders had engaged in a course of conduct that interfered with FMC's business relations and protected corporate rights. Among the protected rights was the right of the shareholders and the company to competent, loyal management elected through the corporate election process.

The recent case *Melamed v. Lake County National Bank* illustrates the significance of the integrity of the corporate governance system and the debtor's right to manage his own business relations free of undue creditor interference. The trustee in bankruptcy in this case alleged several acts of tortious interference: the lender replaced the debtor's accountant with one selected by the lender; the lender retained final approval over all payments made by the debtor; the lender developed a "13-Point Program" to help salvage everything possible from the debtor; and the lender forced the president of the debtor to take a fifty percent reduction in pay. The lender contended that its actions were typical in workout situations and were justified by the economic risks inherent with a troubled debtor. The court rejected the lender's defense and ruled that the evidence was sufficient to support a cause of action against the lender based upon interference.

Interference with a contract between others is privileged when the inter-
ferring party does so in the bona fide exercise of his own rights. In Del State Bank v. Salmon, for instance, the court found that, in certain situations, a lender may interfere with the business affairs of its debtor. In Salmon the president of the debtor corporation was terminated as a result of an alleged interference by the lender. The court rejected the former president's claim and ruled that the lender's actions were privileged. The court stated that "[o]ne may lawfully interfere with the contractual relations of another if by fair means, if accompanied by honest intent, and if to better one's own business and not to principally harm another." According to the court the lender's privilege was based upon its desire to protect its economic interest as a creditor.

Although the lenders in Farah may have acted to protect their legitimate financial interest in FMC's business operations, the court ruled that such an interest did not confer an absolute privilege to interfere in the debtor's affairs. In assessing the extent of the lender's privilege, the court balanced the social benefits of the lender's conduct against the resulting harm. Concluding that the interference resulted in the election of inexperienced officers and directors with questionable loyalty, the Farah court rejected the lender's claim of privilege.


The foregoing discussion reveals that, for the most part, the theories applied in Farah are not unique. Farah is significant, however, because of its application of the traditional theories of fraud, duress, and interference in the context of a debtor-creditor relationship. Prior to Farah similar lender liability cases were based upon the complex theories underlying the concepts

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85. See Black Lake Pipe Line Co. v. Union Constr. Co., 538 S.W.2d 80, 91 (Tex. 1976) ("Interference with contractual relations is privileged where it results from the exercise of a party's own rights or where the party possesses an equal or superior interest to that of the plaintiff in the subject matter."); see also 45 AM. JUR. 2D Interference § 27, at 304-05 (1969) (interference not actionable when justifiable).
86. 548 P.2d 1024 (Okla. 1976).
87. Id. at 1027-28.
88. Id. at 1027.
89. Id.
90. Id.; see also RESTATEMENT (SECOND) OF TORTS § 769 (1977) (actor with financial interest in business of person induced); id. § 773 (asserting bona fide claim).
91. 678 S.W.2d at 690.
92. Id. (citing Frank Coulson, Inc.-Buick v. General Motors Corp., 488 F.2d 202, 206 (5th Cir. 1974) (scope of privilege to interfere determined by weighing of social benefits)). RESTATEMENT (SECOND) OF TORTS § 767 (1977) lists the following social benefit factors for evaluation of privileged interference:

(a) the nature of the actor's conduct,
(b) the actor's motive,
(c) the interests of the other with which the actor's conduct interferes,
(d) the interests sought to be advanced by the actor,
(e) the social interests in protecting the freedom of action of the actor and the contractual interests of the other,
(f) the proximity or remoteness of the actor's conduct to the interference and
(g) the relations between the parties.
93. 678 S.W.2d at 690.
of control and fiduciary relationships. Lender liability cases based solely upon misuse of a controlling relationship are difficult, if not impossible, to maintain successfully.

B. The Control Theories of Liability

A lender who assumes a controlling position vis-à-vis its debtor may be considered to occupy a fiduciary position in relation to the debtor and the other creditors of the debtor. Once accorded the status of a fiduciary, a controlling lender must not misuse its control in relation to the debtor and must act impartially toward competing creditors. Misuse of the fiduciary relation may subject a lender to liability.

Control theories have developed under the instrumentality rule and agency law principles. Liability under the instrumentality rule, also known as the alter ego rule, may occur in cases when a creditor dominates a debtor's business and financial affairs to the point that either the creditor becomes the alter ego of the debtor or the debtor becomes the instrument of the creditor. Courts applying agency law principles may determine that a controlling creditor has become a principal and the debtor has become its agent. Under either the instrumentality or agency theory a controlling lender must deal fairly and impartially with the debtor and the other creditors of the debtor in matters involving the controlled debtor. If a controlling lender breaches its fiduciary duty, its claims may be equitably subordinated to those of the other creditors. The lender may also become liable to cer-

94. See Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). The Taylor case, also known as the "Deep Rock" case, is regarded as the seminal case on creditor control. In Taylor the creditor-parent controlled the affairs of the debtor-subsidiary through its preexisting stock ownership in the debtor-subsidiary. The Supreme Court equitably subordinated the creditor's claim due to the creditor's domination and misuse of the debtor and the creditor's lack of impartiality toward the debtor. The Court relied, in part on Southern Pac. Co. v. Bogert, 250 U.S. 483 (1919). In Southern Pacific the Court stated: "It is the fact of control of the common property held and exercised . . . that creates the fiduciary obligation." Id. at 492. For an analysis of the Taylor case see Herzog & Zweibel, The Equitable Subordination of Claims in Bankruptcy, 15 VAND. L. REV. 83, 104-07 (1961). See also DeBaun v. First W. Bank & Trust Co., 46 Cal. App. 3d 686, 696-97, 120 Cal. Rptr. 354, 359-60 (1975) (bank, as controlling shareholder of corporation, owes duty to minority shareholders and to controlled corporation to investigate with due care prospective purchaser of stock).

Although cases involving the subordination of controlling shareholder claims are often referred to as coming within the Deep Rock doctrine, some commentators have questioned the vitality of the doctrine. According to Professors Carey and Eisenberg, the doctrine "has been interpreted so variously that question may be raised whether there is a 'doctrine' at all." W. Carey & M. Eisenberg, Cases and Materials on Corporations 109 (5th ed. 1980) (footnote omitted); see also Stroia, Deep Rock—A Post Mortem, 34 U. DET. L.J. 279, 296 (1957) (no Deep Rock doctrine exists).


96. In Bostian v. Schapiro (In re Kansas City Journal-Post Co.), 144 F.2d 791 (8th Cir. 1944), the court made the following observations:

"[Equitable] subordination is a means of regulating distribution results in bankruptcy by adjusting the order of creditors' payments to the equitable levels of their comparative claim positions. . . . [I]t fundamental aim is to undo or to
tain third parties for debts incurred by the controlled debtor. The following cases illustrate the application of the instrumentality rule and agency principles in the context of a debtor-creditor relationship.

Courts in the United States thus far have been reluctant to impose fiduciary obligations on controlling creditors. In *In re W.T. Grant Co.* the court held that a creditor, in collecting its claim, owes no fiduciary duty to the debtor or to other creditors. In *Grant* the lenders allegedly manipulated the debtor company to improve their own position to the detriment of other creditors of the debtor. The lenders allegedly forced the debtor to execute security agreements in favor of the lenders in order to secure previously unsecured loans and refused to make further loans to the debtor until the security agreements were executed. The lenders also allegedly used their influence over the debtor to delay a bankruptcy filing until the security interests of the lenders were perfected. The court ruled that a creditor may generally use his bargaining position, including refusal to grant further loans to the debtor, in order to improve the status of existing debts. The court suggested that the lenders would have been derelict in their duty to their own creditors and stockholders if they had not carefully monitored the activ-

offset any inequity in the claim position of a creditor that will produce injustice or unfairness to other creditors in terms of the bankruptcy results. Its most common uses perhaps are to nullify the effect of any fraud that a creditor has committed, to prevent unjust enrichment in a fiduciary relation, and to make the transactions of officers with the corporation conform to their sound realities in the existing situation.

*Id.* at 800.


97. *See In re Teltronics Serv., Inc.*, 29 Bankr. 139 (Bankr. E.D.N.Y. 1983). "In the rare circumstance where a creditor exercises such control over the decision-making processes of the debtor as amounts to a domination of its will, he may be held accountable for his actions under a fiduciary standard." *Id.* at 170. The court in *Teltronics*, however, refused to find a fiduciary relationship between the lender and the debtor and the debtor's other creditors. The lender had no right to participate in the management of the debtor. The lender and debtor did not share any common officers or directors. Although certain covenants gave the lender some control over the borrower, the court concluded that the covenants were neither unconscionable nor unusual. The covenants, inter alia, restricted additional borrowing by the debtor and permitted lender input in the debtor's budgetary process. The court stated: "There is nothing inherently wrong with a creditor carefully monitoring his debtor's financial situation, . . . or with suggesting what course of action the debtor ought to follow." *Id.* at 172 (citation omitted). *See also In re Ludwig Honold Mfg. Co.*, 46 Bankr. 125 (Bankr. E.D. Penn. 1985) (mere offering of business advice to debtor is insufficient control to make lender liable as fiduciary); *In re Osborne*, 42 Bankr. 988, 997 (W.D. Wis. 1984) (to establish a fiduciary relationship the creditor must exercise almost complete control over the borrower's operation); *Delta Diversified, Inc. v. Citizens & S. Nat'l Bank*, 171 Ga. App. 625, 320 S.E.2d 767, 776 (1984) (a confidential relationship does not exist between a bank and its borrowers).

99. *Id.* at 609.
100. *Id.* at 610.
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In Krivo Industrial Supply Co. v. National Distillers & Chemical Corp., the court recognized that if a lender assumes "actual, participatory, total control of the debtor" and if the lender misuses that control, the lender may be liable as a fiduciary. Once again, however, the court refused to hold the lender liable under the control theory. The court noted that ordinarily imposition of a fiduciary obligation on a lender would discourage the extension of credit since the risks and liabilities would be too great. In Krivo the lender agreed to take several steps to assist its financially troubled debtor. The lender provided internal financial management assistance to help the debtor cut costs. A lender representative was responsible for cash management and other financial matters. As a co-signer on all checks he had veto power over all payments. The lender also agreed to help the debtor liquidate unprofitable holdings to provide more capital. The lender additionally agreed to intervene with the government on behalf of the debtor to prevent cancellation of a major defense contract. Ten other creditors of the debtor sought to hold the lender liable for the debts of the debtor company under the instrumentality theory of control. The court found that at all times the debtor existed as a separate and independent corporate body. The court further ruled that "merely taking an active part in the management of the debtor corporation does not automatically constitute control . . . by the creditor corporation." In A. Gay Jenson Farms Co. v. Cargill, Inc., the court found that, by virtue of its status as a controlling creditor, a lender may be liable to noncontrolling creditors of the debtor. In Jenson the noncontrolling aggrieved creditors were farmers who had sold grain on credit to the debtor grain elevator company. The court found that the controlling lender, a working capital financier, engaged in the following acts that led, in part, to liability as a principal: (1) the lender obtained a right of first refusal on sales of grain held by the debtor; (2) the lender obtained the right of approval over the debtor's future mortgages, stock purchases, and dividend payments; (3) the lender obtained the right of entry onto the debtor's premises to conduct periodic checks and audits; (4) the lender included its name on all of the debtor's financial correspondence; and (5) the lender determined that the debtor needed "strong paternal guidance." The court found that the lender's interference in the debtor's affairs constituted de facto control and thus established an agency relationship. Citing the Restatement (Second) of

101. Id.
102. 483 F.2d 1098 (5th Cir.), modified factually, 490 F.2d 916 (5th Cir. 1973).
103. 483 F.2d at 1105.
104. Id. at 1104.
105. Id. at 1109.
106. Id. at 1105.
108. Id. at 291.
109. Id.
110. Id. at 290.
Agency, the court concluded that the controlling lender was liable as a principal for the acts of the debtor in connection with the business. Because the theory of agency necessarily embodies fiduciary principles, the Jenson court implicitly recognized that a controlling creditor may owe a fiduciary duty to its debtor. Under the agency theory the benefit of this duty extends to all noncontrolling competing creditors that may have been injured by the misuse of the controlling relationship. As established in Jenson, a noncontrolling competing creditor may even look beyond the trustee in bankruptcy to the controlling lender in satisfaction of its claim.

The Jenson opinion may be limited, however, to its specific facts and circumstances. By virtue of its right of first refusal on grain sales, the controlling creditor seems to have taken a proprietary interest in the affairs of the debtor. In light of this factor and the inherent propensity of courts in agricultural states to protect the interests of farmers, the Jenson opinion may not be as extreme as it initially appears. Controlling and noncontrolling creditors, however, must be aware of the Jenson approach as a potential source of lender liability.

In another recent case a federal court found that the lender exercised control over the debtor in a manner detrimental to the debtor's unsecured creditors. In In re American Lumber Co. the lender breached its fiduciary duty as a controlling creditor by taking possession of the debtor's plant and by exercising control over the debtor's financial affairs. In addition to receiving all of the debtor's incoming mail, including payments on accounts receivable, the lender approved all payments to other creditors, but only if the payment enhanced the lender's position. The lender also required a substantial

111. RESTATEMENT (SECOND) OF AGENCY § 140 (1958) states: "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." Id. comment a further provides:

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

112. 309 N.W.2d at 290.

113. RESTATEMENT (SECOND) OF AGENCY § 1 (1958) states:

(1) Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act.

(2) The one for whom action is to be taken is the principal.

(3) The one who is to act is the agent.

114. 309 N.W.2d at 290.

115. See also Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 616, 619, 73 Cal. Rptr. 369, 376, 379 (1968) (rejecting contention that lender liable as joint venturer with debtor, but imposing liability based on lender's negligent supervision of debtor).

116. 5 Bankr. 470 (D. Minn. 1980).
reduction in the salaries of the debtor's corporate officers and terminated all of the debtor's employees.

The court found that the lender utilized its power as a controlling creditor in a manner that injured the other creditors of the debtor.\textsuperscript{117} As a result, the court equitably subordinated the lender's claim to the claims of the other unsecured creditors.\textsuperscript{118} The lender contended that subordination of the lender's claim would cause other lenders to foreclose immediately their security interests and collect debts from financially troubled debtors rather than engage in workout practices. The court rejected the lender's questionably noble motives and stated that the lender's conduct in the case could not be allowed to prevail.\textsuperscript{119}

The \textit{American Lumber} case is particularly instructive in light of the remedy awarded. Although the controlling lender engaged in a course of conduct characterized by fraud, misuse, lack of impartiality, and interference, the court granted subordination rather than damages. The noncontrolling competing creditors no doubt would have pursued another theory of lender liability if the bankruptcy estate of the debtor following subordination would have been insufficient to satisfy the creditors' claims.

In sum, the foregoing cases demonstrate the difficulty of maintaining an action for damages against a lender based upon a control theory. Except in suits for equitable subordination the courts appear reluctant to extend fiduciary principles to the debtor-creditor relationship. In contrast to the total domination of the debtor required in the control theory cases, liability based upon the \textit{Farah} theories requires only the allegation and proof of fraud, duress, or interference. While \textit{Farah} involved creditor control, the court did not find it necessary to rely upon the complex control theories.\textsuperscript{120} The facts in \textit{Farah} easily pointed to liability under the straightforward common law tort theories applied by the \textit{Farah} court.

\textbf{C. Implied Covenant of Good Faith and Fair Dealing}

Recently, some courts in the United States have held that a lender may be liable to its debtor for breach of an implied covenant of good faith and fair dealing.\textsuperscript{121} Whether such liability is based upon the common law or upon

\textsuperscript{117} \textit{Id.} at 478.
\textsuperscript{118} \textit{Id.}
\textsuperscript{119} \textit{Id.} at 478-79.
\textsuperscript{120} \textit{See} State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 669 (Tex. App.—El Paso 1984, writ dism'd by agr.) (only fraud, duress, and interference issues decided at trial court level). FMC's petition alleged that: (1) the lenders wrongfully controlled and dominated FMC's business affairs; (2) the lenders subsequently breached that fiduciary duty to the company; and (3) the lenders subsequently breached their fiduciary duty. \textit{See} Plaintiff's Second Amended Petition at 22 (copy on file at offices of \textit{Southwestern Law Journal}). During discovery the relative simplicity of the case became apparent, and the control theories were dropped.
\textsuperscript{121} \textit{See} K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 763 (6th Cir. 1985); Alaska Statebank v. Fairco, 674 F.2d 288, 293 (Alaska 1983); First Nat'l Bank v. Twombly, 689 P.2d 1230 (Mont. 1984). Although the concept of good faith and fair dealing cannot be precisely defined, \textit{Restatement (Second) of Contracts} § 205 comment d (1981) provides the following examples of conduct constituting bad faith: "evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify
the Uniform Commercial Code,\textsuperscript{122} liability for breach of good faith may have far reaching consequences for lenders and their financially troubled debtors.\textsuperscript{123} As the following cases demonstrate, lenders face the possibility of substantial adverse judgments under the good faith theory.

In \textit{K.M.C. Co. v. Irving Trust Co.}\textsuperscript{124} the jury awarded the debtor $7.5 million in damages as a result of the lender's bad faith refusal to finance the debtor's operations.\textsuperscript{125} After experiencing severe financial difficulties the debtor in \textit{K.M.C.} requested the lender to advance funds up to the credit limit on a preexisting, fully secured demand note. Motivated, at least in part, by a personality conflict between the loan officer and the debtor, the lender denied the request. Because all of the accounts receivable of the debtor were deposited in a "blocked account" maintained by the creditor, the debtor existed at the whim of the creditor. The refusal to lend left the debtor with no access to working capital. As a direct result thereof, the debtor's business collapsed.

Relying upon the Uniform Commercial Code,\textsuperscript{126} the court held that, absent a valid business reason, the creditor was under a duty of good faith to notify the debtor of its refusal to lend.\textsuperscript{127} According to the court notice would have afforded the debtor a reasonable opportunity to seek alternative financing, thereby preventing the failure of the business.\textsuperscript{128} The \textit{K.M.C.} court held the creditor liable for the difference between the value of the debtor as a going concern immediately before the advance was refused and the debtor's value after that date.\textsuperscript{129} \textit{K.M.C.} demonstrates that notice prior to action is an essential component of the developing liability theory of good faith and fair dealing.\textsuperscript{130}

In another recent case the court held a lender liable under the good faith terms, and interference with or the failure to cooperate in the other party's performance.\textsuperscript{122} For a review of the development of the tort doctrine of good faith and fair dealing see Seaman's Direct Buying Serv., Inc. \textit{v.} Standard Oil Co., 36 Cal. 3d 752, 774-84, 686 P.2d 1158, 1170-77, 206 Cal. Rptr. 354, 366-73 (1984) (Bird, C.J., concurring and dissenting).

\textsuperscript{122} For a review of the good faith sections of the Uniform Commercial Code see \textit{supra} note 42.

\textsuperscript{123} One commentator characterized the cause of action based on the duty of good faith and fair dealing as "a loose cannon . . . [which] may be used by courts to further their views of justice." Burke, Thomas & Warren, \textit{Emerging Theories of Bank Liability}, in \textit{BANKS AND THEIR BORROWERS: NEW OPPORTUNITIES IN FINANCIAL SERVICES} 403, 458 (1984).

\textsuperscript{124} 757 F.2d 752 (6th Cir. 1985).


\textsuperscript{126} \textit{U.C.C.} § 2-309 comment 8 (1977) states that "the application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute arrangement."

\textsuperscript{127} 757 F.2d at 759.

\textsuperscript{128} \textit{Id.}

\textsuperscript{129} \textit{Id.} at 764.

\textsuperscript{130} One court recently recognized, however, that the UCC good faith requirement does not apply to a demand for payment on a demand note. In Fulton Nat'l Bank \textit{v.} Willis Denney Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980), the debtor sued a lender for damages allegedly resulting from the lender's bad faith termination of a demand note. The court ex-
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theory following the wrongful acceleration of a debtor's note. In First National Bank v. Twombly the loan officer responsible for the note had agreed to convert the debtor's $3,500 secured promissory note into an installment note in order to assist the debtor in repayment of the loan. Because the loan officer was temporarily out of town, the vice president of the lender was responsible for preparing the documents to convert the note. The vice president, however, claimed that he knew nothing about the conversion agreement and refused to convert the promissory note. The vice president subsequently declared the promissory note due and drafted an offset against the debtor's checking account. The debtor was left with a minimal checking account balance and approximately $850.00 of his checks were dishonored. The jury found that the lender breached its statutory duty of good faith and fair dealing by wrongfully accelerating the note and offsetting the debtor's checking account. The jury further found that the lender made false representations to the debtor concerning the conversion of the note. Although the loan agreement expressly precluded punitive damages, the court, on appeal, found that such damages may be awarded when the duty of good faith exists as a matter of law rather than as part of the contract itself.

The duty of good faith and fair dealing has also been extended to the wrongful repossession of collateral. In Alaska Statebank v. Fairco a security agreement provided that if the debtor missed a payment on a $50,000

pressly rejected the debtor's contention that the duty of good faith under U.C.C. § 1-208 modified the fundamental nature of demand note financing. The court stated:

The obligor, by his signature, has agreed that his obligation is on its face "immediately" due and payable and is subject to no other contingencies. Qualifying that obligation by requiring that the holder demonstrate his "good faith" in seeking payment can have no beneficial result for either the holders or the makers of demand instruments.

269 S.E.2d at 918-19; see also Centerre Bank v. Distributors, Inc., 705 S.W.2d 42, 48 (Mo. Ct. App. 1985) (parties by the demand note agreed payment would be made whenever demand was not, not whenever demand was made in good faith); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 518 P.2d 734, 738 n.5, cert. denied, 419 U.S. 967 (1974) (good faith under U.C.C. § 1-203 not fact question in determining a lender's right to call demand note).

131. 689 P.2d 1226 (Mont. 1984).
132. Id. at 1230. For text of U.C.C. § 1-208 dealing with good faith acceleration see supra note 42.
133. 689 P.2d at 1230.
134. Id. The court's decision on punitive damages is subject to criticism for at least two reasons. First, U.C.C. § 1-106 (1977) expressly prohibits the imposition of any punitive remedy. Damage remedies under the Uniform Commercial Code are strictly compensatory in nature. Second, courts should impose punitive damages only if the creditor is, or should be, aware that his conduct is prohibited. The theory of the duty of good faith provides no identifiable standards of prohibited conduct. Punitive damages therefore should not be awarded under the good faith theory. Awarding punitive damages under the good faith theory is inconsistent with more fundamental notions of fairness. See generally Ellis, Fairness and Efficiency in the Law of Punitive Damages, 56 S. CAL. L. REV. 1, 33-53, 76 (1982) (vagueness of criteria and discretion given juries in punitive damage cases causes unfair punitive damage liability); Comment, Sailing the Uncharted Seas of the Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co., 69 MINN. L. REV. 1161, 1187-89, 1197-98 (1985) (punitive damage awards improper in commercial setting when standards of conduct uncertain).

note, the debt would become immediately due and payable. The agreement provided further that the lender could proceed to enforce payment without notice upon default. After the debtor missed two quarterly payments, the senior vice president of the lender assumed responsibility for the note. Following a series of incompletely restructuring negotiations, the lender decided to proceed against the collateral. The lenders, accompanied by a locksmith and a police officer, entered the debtor's business with "an air of self-importance." The debtor's customers were asked to leave, the locks of the store were changed, and the debtor's receipts and accounts were secured. The following day, the debtor regained control of its business and filed suit against the creditor.

The court held that the creditor had breached its duty of good faith to the debtor by failing to notify to the debtor prior to taking possession of the collateral. The court found that by virtue of the incompletely restructuring negotiations the loan agreement was modified and the loan was not in default. The lender, therefore, had no contractual or statutory right to proceed against the collateral. According to the court the duty of good faith required the creditor to notify the debtor in advance of its intention to repossess the collateral. As a result of the lender's breach of that obligation the court awarded the debtor approximately $50,000 in damages, $35,000 of which were punitive damages.

As the foregoing cases illustrate, the duty of good faith, by its very nature, provides no objectively identifiable guidelines concerning the bounds of legally permissible conduct. The duty of good faith and fair dealing simply instructs the lender that "it is right to do right." Yet, in commercial affairs such a mandate is, without further delineation, formless and inconsistent with the basic notion of fairness that notice be given as to what activities are legally permitted or prohibited. If the objective of a legal system is to promote certainty in human affairs, and the authors believe it is, the actionable theory of good faith and fair dealing is too broad and inconstant to serve as a basis of lender liability, as no workable limits to liability exist. Judicial interpretations thus far have not provided clear boundaries of acceptable conduct and the case-by-case approach, while appropriate for a remedial sanction such as an injunction, is not appropriate for the remedy of damages.

D. Prima Facie Tort

At the leading edge of common law lender liability theories is the prima
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facie tort doctrine. A cause of action under the prima facie tort theory may not be brought, however, if the conduct is actionable under an existing, well-defined cause of action. The prima facie tort theory is functionally and theoretically distinguishable from the actionable implied duty of good faith and fair dealing in that it sounds in tort while the duty of good faith and fair dealing sounds in contract and tort. The theories are, however, indistinguishable in application. Both theories require the fact finder to assess the mental state of the actor in the absence of clearly defined standards of unacceptable conduct. The prima facie tort theory, as well as the duty of good faith and fair dealing, is merely "a philosophical effort to state all tort law in a single sentence rather than an effort to state a meaningful principle."

While the number of jurisdictions that have adopted the prima facie tort doctrine thus far has been relatively small, the doctrine will no doubt have a substantial impact upon the scope and magnitude of lender liability. For example, in Centerre Bank v. Distributors, Inc. the lender was held liable under the prima facie tort theory for wrongfully calling a $900,000 secured demand note. In August 1981 the lender notified the debtor that the outstanding demand note would continue for only sixty days. The lender's conduct was motivated by the declining quality of the debtor's collateral and by pressure from bank examiners. Contrary to its representations, however, the lender continued to advance funds and cooperate with the debtor well into December 1981. On December 15, 1981, the lender made formal demand for payment on the note. Two weeks later the lender took possession of the assets and accounts receivable of the debtor.


144. Porter v. Crawford & Co., 611 S.W.2d 265, 268 (Mo. Ct. App. 1980); see also Luxonomy Cars, Inc. v. Citibank, N.A., 65 A.D.2d 549, 408 N.Y.S.2d 951, 954 (1978) (valid business interest justified lender's actions and precluded liability under prima facie tort theory); Motif Constr. Corp. v. Buffalo Sav. Bank, 50 A.D.2d 718, 374 N.Y.S.2d 868, 870 (1975) (same); Holmes, Privilege, Malice, and Intent, 8 HARV. L. REV. 1, 3 (1894) ("the intentional infliction of temporal damage, or the doing of an act manifestly likely to inflict such damage and inflicting it, is actionable if done without just cause").


147. The majority of cases construing the prima facie tort doctrine have been decided by courts applying the laws of Missouri and New York. See Annot., 16 A.L.R.3d 1191, 1201-31 (1967 & Supp. 1985) (citing cases).

148. 705 S.W.2d 42 (Mo. Ct. App. 1985).
The debtor filed suit against the lender alleging that, although the lender's conduct was lawful, the lender's intent was to injure the debtor. The jury returned a verdict against the lender in excess of $7.5 million, consisting of approximately $1.5 million in actual damages and $6 million in punitive damages. 149 The trial court entered judgment on the verdict, but reduced the punitive damage award to $3 million. 150 A Missouri court of appeals, however, reversed the trial court, concluding that the lender's conduct was justified by legitimate business interests to reduce losses resulting from high risk loans. 151

The continued existence of a viable commercial society depends, at least in part, on the ability of business enterprises to structure their operations and plan for the future. Planning requires an evaluation of the opportunities and risks associated with the known and unknown. Unpredictable legal liability complicates planning by enhancing the risks and expanding the unknowns in the legal environment of business. In commercial affairs legal liability must be based upon known, objective standards; therefore, the prima facie tort theory, like the implied covenant of good faith and fair dealing, should not be used by courts as a base of lender liability.

III. EMERGING THEORIES OF LENDER LIABILITY IN PERSPECTIVE

A. General Observations: An Uncommon Common Law Experience

At first glance Farah and the other cases discussed in the preceding section of this Article are but another example of the major transition that is taking place in the United States: From a society that traditionally has been based upon the idea of private assumption of risks the United States is exploding into a compensation-oriented society that uses the laws of civil liability and insurance as vehicles to spread risks and socialize losses. We are not the first to speak of this transformation; it is no new idea. In fact, the transformation is no longer an idea; it is reality. 152 Because traditional concepts of risk distribution between the principal actors in the market place and the public served us so well for so long, their demise was, for many lawyers, unthinkable. Yet, gradually our devotion to traditional principles of liability, such as the principle of caveat emptor, began to give way to a new orientation toward monetary compensation. 153

Farah is not the first case to break out of the traditional framework of debtor-creditor relationships. On the contrary, lender liability is a legal and an economic reality, not an abstraction. Farah will serve, however, as a legal catalyst in an increasingly liability-oriented environment. The Farah case

149. Id. at 44.
150. Id.
151. Id. at 55.
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reflects the notion that the judiciary's traditional reluctance to hold banks liable in the context of their dealings with their debtors is fading away and that in its place is rising a new body of easier-to-prove, behaviorally oriented rules of liability. Banks no longer have the luxury of operating within an environment relatively free from the risk of liability.

Farah may thus far be the only case applying traditional liability theories, such as fraud, duress, and interference, jointly to the debtor-lender relationship, but it is certainly not the only case in which a bank has been held liable to its debtor. Many American courts have gone in the direction of expanding the liabilities of banks and other lending institutions to their customers, even in cases less extreme on their facts than Farah. Not surprisingly, therefore, the debate of the pros and cons of the emerging theories of lender liability ensues. The growing body of legal literature and case law shows an increasing consensus among courts and commentators in the United States that only adherence to unrestricted liability standards will, in the end, be sufficient to protect the interests of all concerned. Judges and commentators apparently are not sure that the banks, who formulate the terms of the legal relationship between themselves and their debtors, are serving the best interests of the debtors rather than their own interests. Regrettably, the expediency of the developing liability concepts thus far has been questioned only rarely.

Both proponents and critics will agree that they knew about most of the

154. For a complete and informative discussion of the emerging theories of lender liability see 1-3 EMERGING THEORIES OF LENDER LIABILITY (H. Chaitman ed. 1985) [hereinafter cited as EMERGING THEORIES].

155. But see Amicus Curiae Brief of the Missouri Bankers Association in Support of Appellant-Respondent Centerre Bank of Kansas City, N.A., reprinted in 2 EMERGING THEORIES, supra note 154, at 1176. The Missouri Bankers Association stated:

The trial court's judgment presents a dangerous precedent to all Missouri banks and borrowers who have occasion to resort to demand note financing . . . . Without doubt, loose application of an undefined and unlimited liability theory to the simple act of calling a demand note could wreak havoc on the ability of Missouri banks to make proper evaluation. Thus, faced with uncertain risks and potentially enormous liability exposure in collecting such notes, Missouri banks likely will be forced to change the terms and increase the cost at which financing is made available to Missouri borrowers. This result obviously would be detrimental both to Missouri banks and borrowers and to the public at large, many of whom enjoy the benefits of capital investments made by Missouri borrowers.

Id. at 1195-96; see also Petition for Hearing, Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, reprinted in 2 EMERGING THEORIES, supra note 154, at 871. United California Bank argued that:

Allowing the tort of bad faith to apply to banks will adversely affect their financial security. . . . [T]he tort permits large, inherently speculative damage awards for emotional distress, coupled with even larger, less controlled awards of punitive damages. Such awards could easily threaten the financial security of many banks. Particularly now, when banks are faced by numerous threats to their financial security and when more banks are failing than at any time since the Great Depression, it is not the time to make matters worse by subjecting banks to potentially disastrous awards of emotional distress damages and punitive damages.

Id. at 897 (footnote omitted). Commercial Cotton is noted in Kitada, Emerging Theories of Bank Liability—The Breach of the Covenant of Good Faith and Fair Dealing, 103 BANKING L.J. 80 (1986).
theories of liability asserted against the defendants in Farah, but that the Farah court for the first time put these theories together and applied them to a case of a bank's undue interference in its borrower's business. The Farah controversy, however, is only an individual event, with an unusual factual background; thus, the case will begin to make sense only through consideration of the common law system as well as the system of banking and financial institutions law within which the case was decided and will operate and have practical effects. These systems thus deserve special attention.

Let us end our discussion of Farah with an analysis of the probable consequences and the possible import of the Texas court's holdings on banking and financial institutions and the public as a whole. Certainly, because of the extreme factual conditions of the Farah case, no one can predict at this point the exact shape and the parameters of lenders' duties to their debtors under the common law liability theories of fraud, duress, and interference. To attempt to describe the scope and contents of the responsibilities and liabilities of banks and other lending institutions after Farah would be to play futuristic guessing games that may prove to be inaccurate or incomplete. Lawyers should not lend themselves to any such speculation as to the future, for, to put it in the frequently cited words of Justice Oliver Wendell Holmes, "[t]he prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law."156

This notion should not prevent lawyers from assisting courts in their endeavor to shape the law of the future or from encouraging legislative action when existing law proves to be inadequate to respond to foreseeable societal needs in the foreseeable future. In his book Tort Law in America: An Intellectual History Professor G. Edward White demonstrates persuasively the seminal role that academicians play in the intellectual upheaval of modern tort law.157 If they in fact are an influential and authoritative force in the evolution of tort law, academicians should be aware that, ultimately, they are ethically accountable to the persons and institutions affected by the doctrinal changes in the law of lender liability. Given this special responsibility, lawyers need to anticipate the foreseeable future by learning from both the present and the past, with the understanding that destiny is what counts, not current trends.158 Legal theories of lender liability are emerging so rapidly that lawyers do not have time to react; instead, lawyers in their respective capacities as judges, legislators, attorneys, administrators, or academicians must now exercise analytical ingenuity and engage in creative imagination to be able to cope with the problem of how the position of lenders vis-à-vis debtors can be secured without violations of the debtors' interests.

Prospective developments should, however, build upon established legal principles. The law regulating banking and other financial institutions reveals a strong traditional momentum reflecting conservative attitudes and

156. Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 461 (1897).
the fear of costly mistakes. Similar considerations apply to the common law and statutory theories of liability of lending institutions to their debtors. These theories need to be developed cautiously because radical changes will have undesirable consequences.

In their endeavor to shape the law of lender liability judges assume a special responsibility. Judges do not write for individual cases alone. When they decide actual cases on the basis of law and equity, judges are contributing to the formation of a jurisprudence that will directly affect similar cases in the future, not merely the case at the court’s hand. Judges are thus responsible for both continuity and innovation in the law of lender liability.

In the remainder of this Article we shall attempt to put the holding of Farah and the legal theories relied upon by the Farah court, as well as other courts, in proper legal and economic perspective. We risk displeasing the numerous tort law experts and banking law specialists who can argue that to take the lead in shaping banking duties in light of the unsettled responsibilities of lenders is too speculative and risky. We also risk displeasing consumerists who will tend to resent the idea of reconsidering liability theories that allegedly well serve the consuming public’s interests. Yet, we think our undertaking is worth the risk.

B. The Place of Lender’s Liability in the Control of Lender’s Conduct


Lender liability theories are emerging at a time of transition for banks and other commercial lending institutions in the United States. The successive deregulation of interest rates, the gradual erosion of traditional boundaries between banks and savings institutions, the evolving system of interstate banking, and the growing significance of so-called nonbank banks have increased competition and taken away limits that traditionally cushioned financial institutions. Whether or not viewed as a blessing, the increased competition between and among commercial lenders has created...
an environment in which financial institutions seem more and more inclined to pursue aggressive and expansionary growth programs in the course of which safe and sound banking practices too often seem to be sacrificed in favor of rapid growth and expansion. These practices result in substantial deterioration in the quality of loan portfolios and sometimes result in significant losses. The economic strains in some sectors of the economy, such as agriculture, real estate, and energy, as well as problems in international lending transactions, are contributing factors to the deterioration of loan portfolios.

As a result, bank failures in the United States in 1985 exceeded the record set in 1984. The former chairman of the Federal Deposit Insurance Corporation (FDIC), William Isaac, recently predicted that in 1986 as many as two hundred bank failures will occur, although the majority of banks in the United States are doing better than ever. Ironically, the availability of depositor insurance, such as the insurance provided by the FDIC and the Federal Savings and Loan Insurance Corporation (FSLIC), appears to

165. Id.
167. The total number of bank failures in 1985 was 120, thus topping 1984's post-depression record of 79. See Wall St. J., Jan. 2, 1986, at 5, col. 3. The 1985 total appears dramatic considering that, between 1934 and 1981, only 722 banks failed, including both FDIC-insured and noninsured banks. W. LOVETT, supra note 161, at 112. Most bank failures involve small, thinly capitalized financial institutions. For a brief discussion of statutory minimum capital requirements in the United States see id. at 106-07.
170. The FDIC was established by the Banking (Glass-Steagall) Act of 1933, ch. 89, 48 Stat. 162, 168 (1933) (codified as amended at 12 U.S.C. §§ 1811-1832 (1982)). For early discussions of this statute see: Willis, The Banking Act of 1933 in Operation, 35 COLUM. L. REV. 697 (1935); Comment, The Glass-Steagall Banking Act of 1933, 47 HARV. L. REV. 325 (1933). The FDIC's original purposes included protection of bank depositors, maintenance and improvement of confidence in the banking system, and promotion of safe and sound banking practices. The Act required all members of the Federal Reserve System, including both national banks and state chartered banks, to obtain insurance through the FDIC. Then, as now, the insurance was also available to applying nonmember state chartered banks that qualified. The FDIC's initial capital was provided by the Treasury and the Federal Reserve District Bank's surplus. Modest insurance premiums paid by the insured banks replenished the FDIC's capital. See generally J. HURST, A LEGAL HISTORY OF MONEY IN THE UNITED STATES, 1774-1970, at 59-60, 200 (1973); Harl, Federal Deposit Insurance Corporation, 6 CORP. REORGANIZATIONS & AM. BANKR. REV. 253 (1947). Today, virtually all banks, whether national or state chartered, are members of the FDIC because most depositors want this protection. W. LOVETT, supra note 161, at 51. For a discussion of the rights and duties of the FDIC vis-à-vis stockholders and creditors of a failed bank see Skillern, Federal Deposit Insurance Corporation and the Failed Bank: The Past Decade (pts. 1 & 2), 99 BANKING L.J. 233, 292 (1982).
171. The FSLIC was created in 1934 to offer deposit account insurance for savings and loans and savings banks. National Housing Act, ch. 847, 48 Stat. 1246, 1255 (1934) (codified as amended at 12 U.S.C. §§ 1274-1735 (1982)). Later, savings banks set up their own state insurance systems. The compulsory state savings bank insurance system in Massachusetts is
have contributed, to some degree, to this development as it protects against the normal risks and natural consequences of bank failures. Yet, leaving aside potential failures of banks, the new competitive atmosphere has affected commercial lending transactions as banks are taking bigger risks in both lending and borrowing activity. The increase in problem loans has triggered workout practices that, in turn, have come under increasing attack by debtors, shareholders, bankruptcy trustees, competing creditors, and others.

Whether or not courts endorse the changes in the legal and economic environment, they must respond to them, and the response has been the evolution of a compensation system. To implement the policy of safe and sound banking while maintaining the balance between lender and debtor, courts began to apply complex liability theories, such as control and fiduciary duty principles, with the application of easier-to-prove fraud, duress, and interference theories now on the horizon. Courts also will not hesitate to resort to novel and still unsettled liability theories, such as prima facie tort and civil RICO. The rise of consumer legislation in the 1970s and its impact upon commercial lending institutions facilitated the evolution of the compensation system because this legislation changed lawyers' views and perceptions of adequate risk distribution in commercial lending transactions. As a re-

still in operation. State insurance plans were established in New York and Connecticut; when these state insurance plans terminated, savings banks in those jurisdictions joined the FDIC. Today, the majority of savings banks in most states except Massachusetts are members of the FDIC. In Massachusetts a few savings banks are members of the FDIC insurance plan as well as the state insurance system. W. Lovett, supra note 161, at 208-09.

172. Theoretically, strong banks should pay lower insurance premiums than banks that are financially more vulnerable. As a practical matter, however, bank regulators cannot make such distinctions publicly without damaging the reputation and deposit business of weaker banks. An additional complication is that some of the largest banks in the United States with heavy international commitments and loan assets have a lower net capital ratio than the average small bank operating exclusively in domestic markets. By this criterion some of the bigger banks should pay higher premiums as well. Another problem with charging for FDIC insurance according to risk is establishing a consensus on an FDIC risk premium schedule and weighing factors relevant to these risks. Still another difficult question is whether the risk premium charged should be disclosed and, if so, to whom. In any event, no strong support exists for any fundamental change in the FDIC insurance system.


175. For a concise survey of the consumer legislation affecting banks and other financial institutions see J. Norton & S. Whitley, supra note 3, § 2.04.
sult, an increasingly popular view is that compensation of debtors is the central purpose of the law.

This idea has particularly infected the courts. Understandably, courts find compensation of debtors appealing. Appellate judges typically must choose between a single plaintiff, often a major employer, who has suffered a loss and a defendant who is a bank, often with substantial assets and seemingly sufficient cash reserves. Judges as well as juries assume that such defendants can readily absorb and widely distribute losses among their customers. The very concept of lender liability is based upon the idea that liability can relieve the suffering of individual debtors through the mechanism of the price/interest system or through insurance. At the same time, debtors often appear unable to absorb the losses very well. Yet the lenders, too, may have difficulty in absorbing the costs of liability judgments or settlements. The financial burden imposed upon banks under the emerging theories of liability may be crushing.\footnote{176 The aggregate effects of these theories thus deserve special attention.}

2. Liability as Part of a Net of Control Devices.

As is evident from the discussion of \textit{Farah} and the other cases, the evolving theories of lender liability, although they may be analyzed separately, cannot be understood apart from the regulation of banks and other lending institutions in general. These institutions operate in a legal, economic, and social context in which public enforcement of duties imposed upon lenders to strengthen the integrity of the banking system has considerable weight. This context is a fairly complex and complicated blend of banking, financial, securities, and antitrust laws.\footnote{177 The emerging theories of lender liability are both part and product of this complex system of regulation. They are part of that system because they are aiming at the regulation's objective that banking be safe and sound;\footnote{178 J. Norton & S. Whitley, supra note 3, § 2.06.} they are a product of that system because existing regulatory, economic, and moral pressures appear to have failed to control effectively all the conduct of lending institutions that society would like to deter.}

But are the developing theories of lender liability likely to promote more desirable conduct on the part of lending institutions than that which would occur in their absence? Can these theories be justified on the ground that they promote socially and economically desirable conduct on the part of lenders? Specifically, can they prevent damage by deterring unreasonable interference in the business affairs of debtors? If the evolving theories of lender liability effectively served deterrence purposes, that success would be a persuasive, or at least powerful, argument for the retention or even expan-

\footnote{176. For a discussion of the arguments advanced by the Missouri Bankers Association see supra note 155.}
\footnote{177. For an analysis of the dual system of banking regulation see Scott, \textit{The Dual Banking System: A Model of Competition in Regulation}, 30 \textit{STAN. L. REV.} 1 (1977).}
sion of these theories. Unfortunately, the deterrence function of expanded liability theories seems insignificant.

To assume that, absent broad liability, bankers will selfishly pursue their own interests, putting their banks' desires and interests ahead of the interests of their debtors, is unreasonable. Bankers will be sensitive to the constraints of law, but also to the imperatives of moral duty, social responsibility, and the commercial value of an un tarnished public image. While the implications of these nonlegal behavioral control mechanisms are not entirely clear, it would, even without empirical inquiries into the causes and effects, seem fair to assume that banks tend to do everything possible to avoid negative publicity from court proceedings, investigations by regulatory authorities, and media reporting. Most, if not all bankers, have a strong moral sensitivity; their pride in doing right and the accompanying embarrassment of doing wrong do provide protection to a bank's customers and debtors. While not all bankers have the proper moral inhibitions against behaving unreasonably and acting in bad faith, "doing right" is internalized as an intrinsic part of a banker's calling. Bankers take considerable professional pride in the integrity of their work. The objective of reasonableness and safe and sound banking is typically critical to bankers' own self-esteem and that of their banks.

The moral pressures are buttressed by market pressures. Traditional banking practices have allocated credit according to the strength of collateral, current and potential earnings, and risk of default, with interest rates and fees reflecting differences in the risks and the respective bargaining powers of the borrower and the lender. Adequate competition among commercial lending institutions helps ensure alternatives in bargaining for loans and interest rates. To create an environment within which such competition can develop, legislatures have enacted numerous statutes designed to limit excessive concentration in the banking market. The United States Supreme Court has been very supportive of attempts to increase competition among banks. The antitrust laws, bank merger and bank holding company legislation, and other regulations thus play an important role in preventing

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181. See, for example, the premerger notification requirement of Clayton Act § 74, 15 U.S.C. § 18a (1982), added to the Clayton Act by the 1976 Hart-Scott-Rodino Antitrust Improvements Act. For a detailed discussion of the notification requirement and the Federal Trade Commission's forms, see Halverson, Volk, Pogue & Pfunder, The Effects of Hart-Scott-Rodino Premerger Notification Requirements on Mergers, Acquisitions and Tender Offers, 48 Antitrust L.J. 1451 (1979); see also Ebke, Uebersicht: Fusionskontrolle in den USA, in Fusionskontrolle in USA 11-37 (Deutscher Industrie- und Handelstag ed. 1978); Ebke, Erweiterte Anzeigepflichten bei Unternehmenszusammenschlüssen in den USA. Hart-Scott-
unreasonable discrimination, undue interference, or exploitation with respect to terms and conditions of credit.

In addition to external pressures resulting from keen competition among banks and other commercial lending institutions, bank directors and officers are subject to substantial control from within their corporations. Courts have repeatedly held that bank directors and officers, because they are in charge of other people's money, owe a special duty of care to their institution and its constituency, the shareholders. Courts have long recognized that directors of financial institutions owe high degrees of loyalty and allegiance to their companies, loyalty that is undivided and allegiance that is not influenced in action by any consideration other than the welfare of their institutions.\(^{182}\) In the discharge of their duties bank directors must, of course, act honestly and in good faith, but honesty and good faith are not enough. Bank directors must also exercise degrees of skill, diligence, and prudence that are typically higher than that required of directors or officers of nonfinancial institutions.\(^{183}\) In light of this more stringent rule, bank directors and officers are inevitably exposed to hostile shareholder lawsuits, whether the actions are primary or derivative.\(^{184}\) Comparative studies show that shareholder litigation plays an important role in policing the corporate system and in controlling the conduct of corporate management.\(^{185}\) Shareholder actions against bank directors would surely have the same effect.

Moral sensitivities, internal control, competitive pressures, and the desire for self-preservation are not of themselves sufficient to provide borrowers and the general public with the necessary safeguards. The threat of potential liability toward debtors is often thought of as a more efficient control device. Will the emerging theories of lender liability be able to help close the gap between how bankers ideally ought to act and how some of them in reality do act? Good reason exists to think that the emerging liability theories will not be fully effective in their operation. Good reason likewise exists to think that the developing compensation system is not only enormously expensive, but that it also sometimes ill serves the debtors' and the public’s interest.

3. Inherent Limitations of Liability Theories.

Proponents of the emerging theories of lender liability will argue that the prospect of liability for improper conduct in connection with workouts acts


as an incentive for banks and other lending institutions to act more with a view to the debtor's interests. Whatever value liability may have in influencing bankers' professional conduct, to suggest that liability does not have any deterrent or preventive value would be incorrect. The deterrent or preventive effects of the liability threat should not, however, be overestimated. The model of deterrence requires knowledge of both facts and law. Yet many bankers seem to be ignorant of the growing threat of liability, in part because of individual inattentiveness and in part because of the fact that not all bankers have the benefit of a legal education and are thus dependent upon their lawyers to provide effective instruction concerning civil liabilities.

The growing number of lawsuits against lenders indicates that changes in the law are not always transmitted to those involved in making fundamental decisions. Even those bankers with broad awareness of their legal duties and responsibilities have many reasons to see the law of lender liability as highly unpredictable. Those reasons include not only doctrinal complexity, rapid legal change, and state-to-state variance, but also the fact that, especially under some of the presently evolving theories of lender liability, the line between prohibited and permissible activities is too often blurred. Thus, for example, the theories of prima facie tort and good faith and fair dealing, because of inherent uncertainties, are not specific enough to provide adequate guidance, to serve as a deterrent to inappropriate banking and financing practices, or to prevent repetition of such practices.

Judicial interpretations thus far have not provided clear boundaries of acceptable conduct. The case-by-case approach is not efficient in terms of deterrence and prevention because the historical experience of a lender in similar cases, or the experience of other lenders, may not be relevant or available. Consequently, a lender may not be able to form a conclusion with respect to a great number of practical questions arising in connection with lending transactions and workouts. In such circumstances the lender's decision ordinarily will be one that, in its opinion, is not susceptible of reasonable criticism. Yet, because of the uncertainties inherent in some of the emerging theories of lender liability, whether the lender's personal assessment and views in fact are consistent with the mandates of the law remains unclear until a competent court resolves the issue in question. Hence, while they may make lenders more cautious in general, the developing liability theories would not seem to deter or prevent all conduct that society regards as unacceptable.

The American legal, political, and economic systems, as well as the banking system, depend heavily upon voluntary compliance with the law and the ability to interpret and implement the law. The expanding complexity of the banking system and banking regulation and the growing competitive pressures in the banking market increase the need for specific rules of conduct. Without such rules society will accomplish little, if anything, in terms of deterrence and prevention. Also, the nature of the damages in the cases under discussion is such that in many workout situations, unlike in *Farah*, bankers cannot become aware that their conduct is harmful until after the
damage or the conduct giving rise to the cause of action has occurred. This aspect, too, supports the proposition that the deterrent and preventive effects of the rising liability doctrines should not be overestimated.

Additionally, the emerging lender liability theories lack direct deterrence. The theory of vicarious liability, respondeat superior, causes debtors to sue the institution rather than the directors, loan officers, or other employees. Banks, like other employers, typically do not exercise their right to seek indemnity from the persons who actually act on their behalf. In some cases, including Farah, indemnification may be precluded by indemnification agreements between the banks and the directors concerned. In many other cases, the bank will carry liability insurance for its directors and officers. As a result, the actual actors are not affected directly in monetary terms by the developing theories of lender liability.

Certainly, a banker who has committed a wrong in the bank's name faces the danger that he may lose his job. Nevertheless, the threat of a job loss lacks substance given the inherent difficulty of isolating personal responsibil-

186. Restatement (Second) of Agency provides that a person conducting an activity through servants or other agents is subject to liability for harm resulting from his conduct if he is negligent or reckless in the supervision of the activity. Restatement (Second) of Agency § 213(c) (1958). See generally H. Reuschlein & W. Gregory, Handbook on the Law of Agency and Partnership 101-04 (1979). For a discussion of the historical origins of the doctrine of respondeat superior see: Holmes, Agency, 4 Harv. L. Rev. 345 (1891); Laski, The Basis of Vicarious Liability, 26 Yale L.J. 105 (1916); Wigmore, Responsibility for Tortious Acts: Its History, 7 Harv. L. Rev. 383, 404 (1894).

187. The question of whether an employer should seek indemnification from an employee appears to be a matter of business judgment and thus should only be subject to limited judicial scrutiny. Recent case law defines the business judgment rule as "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Thus, in a shareholder's action or in a derivative action under Fed. R. Civ. P. 23.1, a shareholder alleging that a board decision was uninformed must rebut the presumption that the board exercised its business judgment in an informed manner. Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); see Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). But see Hasan v. Clever Realty Investors, 729 F.2d 372, 378 (6th Cir. 1984) (finding no presumption of good faith). For a general discussion of the business judgment rule see H. Henn & I. Alexander, supra note 35, at 661-63; Arshy, The Business Judgment Rule Revisited, 8 Hofstra L. Rev. 93 (1979); Comment, Director Liability Under the Business Judgment Rule: Fact or Fiction?, 35 Sw. L. J. 775 (1981).


ity within the system of collective decision-making practiced by banks. Moreover, peer pressure may lead to reservations against a punishment as serious as termination. The effect of a personal stigma upon an employee who acted on behalf of the bank should not, of course, be neglected. In a society as litigious as the United States, however, the personal stigma consideration does not support sufficiently the argument that harsh liability necessarily leads to greater care on the part of an employee. The personal effects that extend beyond a banker's professional career into his life and the stress that can impair his productivity and his emotional and physical conditions are, no doubt, serious concerns. These concerns, however, should not be used as an argument in favor of attempts to broaden existing concepts of lender liability.\(^{190}\)

If both the existing and the emerging theories of lender liability add little, if anything, in terms of deterrence and prevention, the principal purpose of, and the moving force behind, those theories is the shifting of financial risks from the debtor to the lender. Such allocation of risk, however, rarely achieves the anticipated economic and social goals. As a general rule, when a bank or a similar financial institution is liable to a debtor or when a bank settles a doubtful case of potential liability to a debtor, the bank impairs its capital. Such impairment arguably would be acceptable if it adversely affected only the shareholders of the bank. Such impairment would seem to be a normal and natural risk of an undertaking such as a bank. Most regrettably, however, more than just the shareholders are affected.

Large liability judgments, such as the ones awarded in *Farah*,\(^{191}\) *K.M.C.,*\(^{192}\) and *Sanchez-Corea*\(^{193}\) add substantially to the costs of financial institutions without adding anything to their revenues. Since the banks' costs are then higher, the banks will demand a higher interest rate for loans or higher fees for banking services. As interest rates and fees rise, prices of the debtors' products or services will rise since the debtors will, at the next possible occasion, pass the increased costs on to their customers. Increased costs, then, represent a loss to the public at large, a social loss. The imposition of broad liabilities upon banks in connection with workout situations thus turns out to be no more than a loss-spreading technique with high transactional costs\(^{194}\) related to the United States' custom of lawyers usually being paid by the hour rather than according to statutory fee schedules. To put it differently, the emerging liability theories, if overemphasized, tend to...

\(^{190}\) See Ebeke, *In Search of Alternatives*, supra note 83, at 685.


\(^{192}\) K.M.C. Co. v. Irving Trust Co., 757 F.2d 752 (6th Cir. 1985) ($7.5 million damage award).


\(^{194}\) For a discussion of the inefficiency of a system of broad directors' liability see Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 DUKE L.J. 895. Professor Conard suggests a ceiling on damages awarded for directors' negligence because unlimited liability would be uninsurable and unindemnifiable. *Id.*
take away from bank customers some of the financial benefits that deregulation schemes and modern consumer laws meant to give them.

The emerging theories of lender liability are not only financially burdensome to debtors, depositors, and the public in general; they also result in further concentration in the banking market. Use of the broad term "lenders" tends to lead to the assumption that lenders are a fairly homogeneous group of financial institutions with similar interests. That assumption does not appear justified. Whereas large financial institutions may very well be able to absorb or distribute items of increased cost such as liability judgments or settlements, many small or medium-sized lending institutions find themselves in a totally different position. Large liability judgments, made possible by the developing liability theories, or settlements, encouraged by the possible exposure to potentially enormous liability, could bankrupt banks and thrift institutions that are not as strongly capitalized as their major competitors. If only the financially secure institutions can absorb or distribute liability costs, large damage awards based upon liberally applied substantive liability rules, coupled in some cases with awards of punitive damages, will, in the end, lead to more concentration in the banking market and to a curtailment of the benefits of competition. Although concentration may ultimately enhance the soundness and stability of the financial system, the removal of less strongly capitalized financial institutions may not prove beneficial for depositors and debtors since less competition will almost inevitably result in less favorable terms on loan and deposit transactions. Viewed from this angle, inherently formless liability theories such as control, bad faith, and prima facie tort will, in the final analysis, disadvantage, not protect, depositors, debtors, and the consuming public by reducing competition and raising interest rates and banking service fees.

Far-reaching civil liabilities based upon inherently uncertain legal theories may also cause socially and economically undesirable defensive banking practices, including increased use of personal guarantees, demands for substantial collateral, and preparation of documents with a view toward creating defenses. The gravest danger of the new liability theories is that they will create an overly cautious banking system. In that event the likelihood is that companies and individuals will soon be heard to complain of banks refusing to grant loans, not because the banks think the loans unreasonably risky, but because the banks choose to minimize the risk of getting caught up in what they perceive to be an expensive liability theory lottery. Defensive banking practices thus may hinder the entrepreneurial revolution that the United States has witnessed in recent years. We need legal rules with proper economic incentives for banks, not rules that take away incentives.

Even this discouraging news has a bright side, however. The emerging theories of lender liability, no doubt, will create a higher demand for the

196. Similar concerns arise in the area of professional malpractice liability. See Ebke, In Search of Alternatives, supra note 83, at 690-91.
estimated 675,000 lawyers in the United States. The increasing number of lawyers will find a growing market for legal and consulting services. Special programs sponsored by various professional organizations will help bankers and their corporate and litigation counsels acquire the substantive knowledge and the procedural skills that they need to master the growing number of cases in this area. The future of the developing liability theories depends, in the final analysis, upon the extent to which corporate counsels and litigators are skilled in utilizing the theories and upon their willingness to test them in court. Nevertheless, the special interests that certain members of the legal profession may have as private attorneys general in the emerging field of lender liability law do not, without more, seem to outweigh the disadvantages of the developing liability system to lenders, borrowers, and the general public.

4. The Need for a Conceptual Reorientation.

Because of the disadvantages of the developing liability system, banks and other lending institutions, their customers and debtors, as well as judges and lawyers, need to reorient their thinking, reevaluate their conduct, and reconceptualize their objectives and strategies. New modes of thinking and new orientations are needed if the regulation of the banking industry is to achieve its primary goals: to assure financial security of lending institutions and hence of the deposits they hold, and to provide the economy with capital at affordable interest rates. In modern service and information societies such as the United States the driving force and key to economic achievement, development, and progress is capital; capital represents access to resources, including technology and information. The uninterrupted flow of affordably priced capital thus is vital for trade, productivity, economic growth, societal prosperity, and individual well-being. With this in mind, the parameters of a lender's responsibility ought to be determined. The end of the safe harbor theories will free the energies of judges, lawyers, and academicians to entertain the problems and opportunities of the existing and emerging theories of liability of banks and other commercial lending institutions.

The need for a solution places a special responsibility upon judges. The existing body of lender liability law in the United States should be understood as a series of emergency and otherwise corrective and protective measures designed to be helpful, rather than as a single master plan or ideological program. The liability theories that are extant today or currently evolving are not the product of a carefully thought-through plan. The dominant theme is pragmatism and the idea that the courts should act to compensate debtors and to restore and maintain confidence in financial matters and the banking system as a whole. In adhering to that theme, courts are attempting

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198. The course materials of a recent program of the American Bar Association are contained in 1-3 Emerging Theories, supra note 154. The Practising Law Institute has also conducted a program on the developing theories of lender liability. These materials are reproduced in Burke, Thomas & Warren, supra note 123, at 403.
to implement the policy of safe and sound banking within the lender-debtor relationship. The relative flexibility of the common law doctrines in question and the plaintiff-oriented rules of procedure in the United States\textsuperscript{199} give American courts real leverage to shape, at least to some degree, the development of lenders' liability. As stated earlier, the body of principles that have developed in this ad hoc fashion by now is a substantial and impressive one. Without doubt, courts should wield their power in order to help fulfill the objective of fair banking in commercial lending transactions. How far the courts should go is, as in other areas of the law, a matter of degree.

Cases as extreme as \textit{Farah} are particularly apt to be cited in support of the proposition that private enforcement of lenders' duties by means of civil liability actions ensures fair dealing and prevents unreasonable interference or exploitation by lenders with respect to terms and conditions of credit. \textit{Farah} directed our attention to a number of questionable banking practices of well-established financial institutions in their dealings with a financially and otherwise troubled debtor. Yet, hard cases do not necessarily make good law.\textsuperscript{200} The choice is not one between the present compensation system and its simple repeal. We are not advocating that the lender liability theories be abandoned, but rather that the emerging theories of lender liability be applied cautiously and that the compensation model take account of many other important regulatory factors. True, no neat dividing line exists between too much and too little liability, but we can impose self-restraints on the liability system by revitalizing control devices other than liability actions. The \textit{Farah} case is a particular illustration of the need for a balanced approach to the solution of the overall problem. The level of change of development reflected in the \textit{Farah} decision is so fundamental, yet at the same time so subtle, that the change might be viewed as inevitable in light of the extreme facts of the case. To view the change as inevitable, however, would ignore the potential impact of this decision on lenders in the United States. It would also ignore the regulatory and economic contexts that appear to give rise to a higher demand for workouts.

These regulatory and economic contexts are in a state of transition. The banking industry is clearly experiencing numerous uncertainties. In this situation courts should not create additional uncertainty in the law governing commercial lending transactions by creating vague and open-ended causes of action and applying existing causes of action in ways in which they were never before applied. The emerging compensation system could, of course, merely be a reaction to the changing environment of financial institutions; the new approach could dissolve as soon as the banking system as a whole is in balance again and the overall economic situation improves. Yet, while the creation of unprecedented compensation theories may be difficult, retreat from the broad parameters of liability exposure engendered by the courts

\textsuperscript{199} See Ebke, \textit{In Search of Alternatives}, supra note 83, at 687-88.

\textsuperscript{200} For the famous remarks of Justice Oliver Wendell Holmes see Northern Sec. Co. v. United States, 193 U.S. 197, 400 (1904) (Holmes, J., dissenting) ("Great cases, like hard cases, make bad law.").
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will be even more difficult since every compensation system creates expecta-
tions on the part of those who are potential beneficiaries of that system. We
are about to permit the compensation system to become excessively individu-
alisitic by extending the benefits of compensation to larger and larger num-
bers of borrowers. Such individualistic expectations, once created, cannot be
eliminated without hardship. Accordingly, it is vitally necessary to balance
the economic and regulatory environment within which the lender-debtor
relationship operates before further expanding lender liability theories. The
new lending limits for national banks\textsuperscript{201} and the proposed regulation by the
Federal Home Loan Bank Board that would require thrift institutions to
raise capital levels over the next several years\textsuperscript{202} are promising beginnings.
Only if those who are responsible for balancing the regulatory and economic
environment fail, should courts utilize their judicial powers to provide debt-
ors and others with the necessary safeguards.

Banks and other commercial lending institutions, too, need to reorient
their thinking and conduct.\textsuperscript{203} Organizational precautions, improved infor-

mation flows between bank officers and directors, better training of employ-
ees, full and fair disclosure of the bank's major decisions concerning the
debtor, careful drafting of documents, updating of forms, more legal educa-
tion, and an efficient internal control system may help restore and maintain
the balance between debtors and lenders in commercial lending transactions.
Additionally, bankers should not worry so much about short-term earnings,
up-coming financial statements, and bonuses based upon short-term per-
formance, but rather should concern themselves with the firm's long-term
activities. Bankers have to become more sensitive to the long-range implica-
tions of their short-term actions and decisions. The prudent investor-share-
holder should appreciate and support a proposed change in management
perception.

Borrowers, too, should become aware that they can and ought to do some-
thing to improve their position vis-à-vis their lenders. In working out their
financial or other problems with their bankers, borrowers should bring their
own legal counsel in order to put themselves on a par with the financial
institutions and their legal counsel. Borrowers should not accept manage-
ment change clauses and other similarly restrictive covenants in any loan
agreements if they have reason to believe that they will be unable to cope
with the influence that such clauses may permit the lenders to exercise
within the lender-debtor relationship.\textsuperscript{204} Furthermore, borrowers and their

\textsuperscript{201} For a thorough discussion of the new lending limits see: Norton, \textit{Lending Limits and
Bank Lending Limits—A New Framework}, 40 \textit{BUS. LAW.} 903 (1985). Lending limits have
undergone various transformations since their inception in 1863. For a discussion of the statu-
tory history of lending limits laws see Glidden, \textit{National Bank Lending Limits and the Com-


\textsuperscript{203} See Norton, \textit{Theories of Lender Liability: Practical Lessons for Lenders and Counsel},

\textsuperscript{204} Judge Higginbotham, in a separate action involving the management change clause in
\textit{Farah}, see supra note 24, stated: "[t]he relationship between the lenders’ business interest and
attorneys need to accept the fact that lenders' pockets may not always be deep enough to permit recovery if the borrowers themselves cannot resolve the problems that originally necessitated the adoption of management change clauses. Finally and importantly, borrowers need to realize that the theory of lender liability to debtors needs to be implemented with restraint as it involves the judicial determination of public policy; the emerging theories of lender liability are not meant to be a judicial device that enables a court to impose randomly its sense of justice and fairness on a market place dependent upon supply and demand in arriving at contractual terms.

IV. Conclusion

The great lesson, we think, that can be drawn from the growing body of case law of lender liability is a modern version of the ancient Greek ideal μηδὲν ἄγαν (balance), balance between a lender's interest in assuring repayment and the debtor's interest in freedom from undue interference by the creditor. Where to draw the line, of course, cannot be stated in terms of an abstract rule or principle. Courts need a certain flexibility in deciding the kinds of cases discussed in this Article since such decisions are dependent upon many factors. Courts should, however, closely coordinate existing and emerging liability theories so as to create a body of coherent principles and rules that give commercial lenders fair notice that certain activities are unacceptable and may result in liability and that provide courts, attorneys, and all concerned adequate guidance as to whether and how a lender's conduct resulting in economic harm to a debtor can be remedied. In their endeavor to shape the lender liability law of the future, courts should remember that an overexpansion of liability theories, irrespective of how noble the judiciary's motives may be, is more likely to upset the present balance between the adverse interests of lenders and debtors than attempts to proceed cautiously toward a rational body of principles and rules. Courts should also remember that radical changes in the law of lender liability are better wrought by the legislatures.

In any event, borrowers, depositors, lenders, and society will be decidedly better off if courts and legislatures keep lenders' liability within reasonable


The lenders expressly conditioned the loan on a provision that, in effect, gave them substantial influence over the composition of FMC's executive management. FMC did not have to agree to such a relationship, but it chose to do so. It simply stretches credulity to believe, as Farah has implied, that FMC did not understand that the default provision gave the lenders great influence in determining who controlled the affairs of FMC. The lenders bargained for and obtained a contractual provision that enabled them to protect their interest from adverse changes in FMC's management. It necessarily was understood that the lenders would use their right to declare an event of default as leverage in obtaining a management most agreeable to their interest in protecting the loan.

*Id.*, reprinted in part in Application for Writ of Error at 5-6.
limits. Too much reliance upon private enforcement of a lenders' duties leads to imbalance, neglects important and potentially efficient regulatory and other control devices, and results in adverse financial and economic consequences. The legislatures should do whatever may be necessary to provide a legal, economic, social, and political environment within which banks can operate in their own best interest and that of their debtors, depositors, and the public at large.